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Scottish Affairs Committee

The Proposed Whisky Strip Stamp

Third Report of Session 2003–04

*Report, together with formal minutes, oral and
written evidence*

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The Scottish Affairs Committee

The Scottish Affairs Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Scotland Office (including (i) relations with the Scottish Parliament and (ii) administration and expenditure of the office of the Advocate General for Scotland (but excluding individual cases and advice given within government by the Advocate General)).

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1 Introduction

1. On 10 December 2003, the Chancellor of the Exchequer announced in his 2003 Pre-Budget Report that, in order to combat spirits fraud, the Government planned to legislate in the 2004 Finance Bill for strip (or tax) stamps – that is, a gummed narrow paper label affixed over the closure of a bottle of spirits, to indicate that duty has been paid to be put on bottles of spirits sold in the UK.¹ The Report also stated that the Government would consider any new proposals the spirits industry wished to put forward in the coming months for “alternative measures which would be as effective in tackling spirits fraud as tax stamps”. The proposal had its origin in the July 2001 Report by John Roques into the collection of excise duties. As a result of consultations carried out, the Government decided not to proceed with tax stamps at that time and instead to pursue other options.

2. The Scottish Affairs Committee announced on 11 February 2004 that it would undertake an inquiry into the possible consequences for the Scotch whisky industry of such an action. The Scotch whisky industry had reacted with dismay to the Chancellor’s announcement in his Pre-Budget Report,² and the Committee received written submissions from CBI Scotland,³ the Scottish TUC⁴ and the Scottish Council for Development and Industry⁵ all opposing the possible introduction of strip stamps.

3. The Committee held four sessions of oral evidence,⁶ taking evidence from the Scotch Whisky Association, HM Customs and Excise, the Ardbeg, the Bowmore, the Bruichladdich and the Kilchoman Distilleries, the Wine and Spirit Association and Mr John Healey MP, Economic Secretary to HM Treasury. In addition, the Committee undertook a series of informal visits on Islay, (to the Lagavulin, the Laphroaig, the Bunnahabhain, the Bruichladdich and the Bowmore Distilleries), to the Edrington plant in Anniesland, the Chivas plant in North Paisley and - as we acknowledge that strip stamps would also affect the UK Irish whiskey industry – to the “Old Bushmills” Distillery in County Antrim.

4. The Committee also visited Washington DC, where we met officials from the British Embassy, from the Alcohol and Tobacco Tax and Trade Bureau of the US Treasury Department, from the Bureau of Alcohol, Tobacco, Firearms and Explosives of the US Justice Department, and representatives of the Distilled Spirits Council of the United States, Inc.. Whilst in America, we took the opportunity to visit the Diageo Global Supplies plant in Relay, Maryland.

¹ *The strength to take the long-term decisions for Britain: Seizing the opportunities of the global recovery. Pre-Budget Report December 2003*, Cm 6042, para 5.104

² See Press Release of 10 December 2003 from the Scotch Whisky Association (not reported)

³ Ev, p 80

⁴ Ev, p 81

⁵ Ev, p 82

⁶ Three of the evidence sessions were held in Westminster; the session with Islay distillers was held on Islay

5. Responding to an invitation extended to the Committee by the Economic Secretary when he appeared before us,⁷ we visited HM Customs and Excise for a confidential briefing with Customs law enforcement investigators.

6. We wish to offer our thanks to all those witnesses who gave oral evidence to the Committee, and to our interlocutors in both the UK and the US who gave up their time to meet us and to provide invaluable background information.

7. The Chancellor's Budget Statement of 17 March 2004 confirmed that he would be pursuing the strip stamp option and that provisions would be included in the Finance Bill to enable such stamps to be fixed to bottles of spirit with effect from April 2006.⁸ Several measures to reduce compliance costs were announced, notably Customs paying for the printing and distribution of stamps, seeking to ensure that tax stamps do not have to be paid for "upfront", and a £3 million fund for capital grants to smaller firms. On 23 March 2004 the House voted by 309 to 205 to approve the Resolution on which these legislative provisions can be founded. We determined that we would agree our Report and make it available to the House in time for the Committee stage of the Finance Bill, to enable those Members seeking to participate in the debate to be aware of our views.

8. Although throughout this Report we invariably refer to "Scotch whisky", most of our comments do, of course, apply equally to all spirits – whether Scotch whisky, Irish whiskey, vodka or gin – and to all the people involved in their production, distribution etc.

2 Identifying the level of fraud

9. At the heart of the Government's proposal, and of this inquiry, is the need to tackle fraud in the spirits industry. Consultations between the Government and the industry have been ongoing for several years; as HM Customs and Excise said in its Regulatory Impact Assessment *Excise: Tackling Spirits Fraud* ("the RIA"):⁹

"For the last 3 years the Government has been actively considering the most effective and appropriate response to the problem of spirits diversion fraud. During that time it has held two formal consultations with the alcohol industry to examine, first, the introduction of tax stamps and, second, a range of regulatory proposals designed to restrict the sale and movement of duty-suspended alcohol.

"Following the tax stamps consultation in 2001-02, the Government concluded that, although tax stamps were an effective response to spirits fraud, the compliance costs of tax stamps for the legitimate spirits industry would be disproportionate to the benefits. It therefore decided, in the 2002 Budget, not to proceed with the introduction of tax stamps at that time. Instead, a range of other measures were adopted, based on enhanced co-operation between Customs and the spirits industry.

⁷ Q335

⁸ See *Official Report*, 17 March 2004, col 329

⁹ Published 8 April 2004

“Following the second consultation, on regulatory options, in 2003, the Government concluded that, while some of the measures would have a positive impact in helping to counter alcohol fraud across all sectors of the industry in the short to medium term, the most significant proposals - to radically reduce the movement and sales of alcohol in duty suspension - would not deliver an anti-fraud benefit that was proportionate to their compliance cost to the industry.

“In the meantime the level of spirits fraud in the UK continued to rise. In December 2003, Customs estimated that the fraud had cost the Exchequer £600 million in 2001-02 and was on an upward trend. In the 2003 Pre-Budget Report, the Chancellor therefore announced that he would legislate for tax stamps in the 2004 Budget unless the industry put forward an equally effective alternative. Customs cautiously estimate that the anti-fraud impact of tax stamps will be £160 million in 2006-07, in their first year of introduction.”¹⁰

10. Both the Government and the industry agree that there is fraud in the spirits industry, and both sides are resolute in seeking to tackle such fraud. But from the outset of the inquiry, we were aware that there was a basic problem – no-one, it seemed, had any real idea of the true scale of the fraud. Some estimates are based on actual cases detected. In their written submission, HM Customs and Excise gave illustrative examples of the amount of excise duty and VAT evaded by recent instances of *outward diversion*, (ie, when product leaving a UK location intended for either another UK destination or another EU country is diverted onto the UK market), was £1.3 million in duty and VAT evaded on 10 consignments, and of *inward diversion*, (ie, when goods legitimately leave a production or storage facility in another country, are imported into the UK, and then are diverted onto the retail market without payment of UK excise duty), was £70m in duty and VAT evaded on 400 loads of spirits.¹¹ Customs estimates that inward and outward diversion are of comparable scale.¹²

11. The principal means of estimating fraud is to compare estimates of consumption with actual excise receipts: “gap analysis”. The Government and the trade have come up with wildly different estimates. This uncertainty as to the level of fraud was highlighted by the publication on 11 March 2004 of a report from the National Audit Office (NAO), *Estimating the level of Spirits Fraud*. The Economic Secretary said in his written submission:

“Customs’ estimates, published alongside the 2003 Pre-Budget Report, showed that around £600m of revenue was lost through spirits fraud in 2001-02. In January 2003, the Scotch Whisky Association put forward an alternative estimate, based on a different set of data and assumptions, showing fraud at a level of £100m to £150m. In February, the Public Accounts Committee asked the National Audit Office to examine the basis for the differences between the estimates. The Government welcomed this work and the National Audit Office was given the full cooperation of Treasury and Customs officials in conducting it.

¹⁰ RIA, p 5

¹¹ Ev, pp 20-21

¹² Ev p 24, RIA, *op cit*, p 14

“The NAO’s report...recognises that measuring illegal activity is inherently difficult. It confirmed that Customs’ estimate is reasonable but suggested that, given the high degree of uncertainty attaching to such estimates, it should properly be expressed as a range from £330m to £1,080m. The report also concluded that the estimate put forward by the SWA should be expressed as a range from £10m to £260m and is also reasonable.”¹³

12. However, the Economic Secretary is somewhat selective in his quoting of the NAO report. The NAO does indeed consider both Customs and the Scotch Whisky Association’s methods of collecting data to estimate consumption “to be reasonable to professional statisticians”¹⁴, but the report continues:

“But it is difficult to accept that both methods are reliable when they result in such widely different estimates of consumption. It is therefore clear that further work needs to be done by the Office for National Statistics, with Customs and the Scotch Whisky Association, to explain why there are such different estimates for consumption and therefore alcohol fraud. It is welcome that the Office for National Statistics are considering a longer term project to explain the contrasting results of the General Household and Expenditure and Food surveys, and further work to identify ranges for General Household Survey-based estimates. In the meantime, neither survey estimate can be accepted as unequivocally reliable and great care is needed in determining what reliance is to be placed on the results at present available.”¹⁵

13. Because of the uncertainty over the level of spirits fraud, the Chairman of the Committee wrote on the NAO report’s publication to the Chancellor of the Exchequer on 11 March, urging caution:

“...in making any announcement in your forthcoming Budget Statement on ways to tackle fraud in the spirits industry which might be in reaction to uncertain data. My Committee was not totally convinced by the assessment made by either the industry or by Customs of the level of fraud, an uncertainty now clearly shared by the NAO. To base an important decision, which could have serious implications for a major UK industry, on figures which may be flawed and on which the NAO say further work must be done, would seem to be unduly hasty and unwise.”¹⁶

14. We regret to say that we did not receive a reply from the Chancellor giving his reaction to the Chairman’s letter. The Economic Secretary, in his written submission, said that the Government:

“...accepts that where there is fraud there will always be uncertainty about its scale. But this cannot be an argument against taking tough action to combat criminal fraud and protect the public finances.”¹⁷

¹³ Ev, p 64

¹⁴ *Estimating the level of Spirits Fraud*, Memorandum by the Comptroller and the Auditor General, para 10

¹⁵ *ibid*

¹⁶ Ev, pp 62-63

¹⁷ Ev, p 64

15. We accept the general truth as advanced by the Economic Secretary. But it has become something of a cliché that “doing nothing is not an option”. We do not necessarily agree that every recognised form of criminal fraud requires an instant response. Caution should not be confused with inertia. The differences in the estimates of spirits fraud are so fundamental – the estimates do not overlap even marginally at any point in their ranges – that the Government cannot logically make such an important decision as the introduction of strip stamps based on figures which may be flawed.

16. It is absolutely right that the Government and the Scotch Whisky industry tackles the level of fraud in the industry. However, we believe that the Government’s plans to introduce strip stamps are a response to a level of fraud that it estimates to be £600m a year, meaning almost 1 in 6 bottles of spirits consumed in the UK not having borne UK duty.¹⁸ If the alternative estimate of barely a quarter of that were accepted, it could not but affect the Government’s view of the extent to which the costs of a strip stamp scheme were proportionate to the benefits – as it clearly did in 2002. Until definitive figures are available, no estimate, whether from Customs or from the industry, can be accepted as accurate. For any Government to introduce important measures which could have major implications for industry and employment, based on what could be inaccurate figures, might be considered precipitate to the point of being reckless.

3 The best way to combat fraud?

17. It is highly questionable whether strip stamps are the best way to combat fraud. We have been told that there are four main flaws to the stamps. Firstly, a bottling plant needs a particular, and very expensive, type of machinery to put the stamps on the bottles. We heard of one example of the damage that could be caused to a community by the introduction of strip stamps when we visited Bushmills. The distillery employs 130 people from a village of some 1,000. Of those 130, only 30 were employed on distillation. The remaining 100 employees work in the bottling plant. Should strip stamps be introduced, Bushmills’ current machinery would not be able to fix the stamps on the bottles, so new machines would be necessary.

18. Irish Distillers Limited (IDL), (which own Bushmills and are, in turn, part of the Groupe Pernod Ricard), currently have three bottling plants on the island of Ireland – at Bushmills and at two in the Republic. One of the bottling plants in the Republic is to be closed shortly, leaving Bushmills and IDL’s plant in Dublin. The latter already has a strip stamp machine. It could therefore make good business sense to consolidate all of IDL’s bottling operations at the Dublin plant, and to close down Bushmills’ bottling plant. This would be catastrophic for the village of Bushmills; not only would 10 per cent of the population of the village lose their jobs immediately, but other employment dependent on the distillery – eg, electricians, plumbers and builders – might also be lost. In addition, other businesses in the village, such as the local garage and the supermarket, would inevitably suffer.

¹⁸ Ev p 21, para 8: RIA, *op cit*, page 16

19. Of course, Bushmills is not unique. During our visits, we heard similar stories of how fragile communities on, for example, Islay and in areas of high deprivation, such as Springburn, could be similarly affected. Bottling plants are likely to close down as large distillers rationalise their plants. Smaller distillers and bottlers may be obliged to cease operations totally, faced with having to buy new machinery costing, we were advised, between £750,000 and £2million. Additionally, there are only two companies – one in Germany, and one in Italy - that make the relevant machinery. Even if a company could afford to buy the new machines, it might face the problem that those machines would not be delivered in time for the introduction of the stamps.

20. The second flaw with strip stamps is their physical nature. During our visit to the United States, it was put to us that a thin, sticky label stuck over the top of a bottle was a nineteenth century solution to a twenty-first century problem. We agree. At one of the bottling plants we visited in Scotland, we saw many examples of stamps having become snagged in machinery and consequently ripped, or not having adhered to bottles properly. They then had to be manually recorded, and stuck onto a list on a clip board, as having been rendered useless in order for the bottling plant to claim a refund from the relevant country.

21. The third problem is that the strip stamps would be easy to counterfeit. The memorandum from the Scotch Whisky Association (SWA) told of what had happened in one Eastern European country:

“A recent example was the Ukraine’s decision to reformulate its tax stamps system on 1 January 2004 in an effort to defeat widespread fraud of existing stamps. Within three weeks, we understand the Ukrainian police had reported the seizure of 66,000 bottles of illicit spirits each marked with forgeries of the newly introduced state of the art hologram seals.”¹⁹

22. When we put this matter to the Economic Secretary, his response was meant to be reassuring:

“I am aware of those sorts of stories. In many ways, and I have seen some of these for myself, one has to say that the design of some strip stamps in some of the countries which operate them incorporate no security features at all and it is perfectly possible to get good copies from a photocopier frankly. With the Ukraine, in many ways I would suggest that it is not necessarily a good exemplar to compare with the UK. Many of those former Soviet states are bedevilled by levels of systemic corruption and fraud which do not make them directly comparable, I would say, to a country such as ours.”²⁰

¹⁹ Ev, p 5, para 6.3

²⁰ Q343

23. We regret to say that we feel such a response is verging on the complacent. If forgers have no difficulty in reproducing passports, then counterfeiting a label about 12 cms long and 2 cms wide should not pose too many problems. Indeed, we drew the Economic Secretary's attention to newspaper reports that counterfeiting gangs in China were just waiting for the stamps to be introduced in the UK.²¹ We trust that he has noted, and will act on, these reports.

24. The final problem was set out in the SWA's written submission; legitimate stamps could actually exacerbate the problem of fraud by making counterfeit spirits appear genuine:

“The evidence from Central and Eastern Europe is that genuine tax stamps can be used to disguise breaks in seals after re-filling and that unscrupulous traders use stamps to add authenticity to counterfeit product. There is evidence of Spanish tax stamps appearing on spirit drinks to add legitimacy to products being sold in the Philippines.”²²

25. Whatever the actual level of fraud in the spirits industry is, we accept absolutely that it will not disappear without appropriate action being taken. We are convinced that there has to be a better alternative to strip stamps; we are very far from convinced that the Government has fully considered all possible alternatives.

4 The industry's proposals for tackling fraud

26. The Scotch whisky industry has submitted seventeen alternative proposals to strip stamps;²³ these are summarised below:

Proposal 1 Notification of movements

The trade will assist Customs by providing information about duty suspended movements falling within parameters designed to indicate potential irregularities. This will enhance the ability of Customs operational staff to focus their attention to movements on an improved risk assessment basis.

Proposal 2 Guarantees

The trade will adopt a code of best practice throughout the industry aimed at denying the availability of movement guarantees to fraudsters and so inhibit fraudulent movements.

²¹ QQ375-376

²² Ev, p 5, para 6.8

²³ See, for example, Ev p 2

Proposal 3 Registration of owners moving goods

Customs to consider registering the owners of goods during duty-suspended movements in addition to owners of goods in warehouse to deter fraudsters, particularly those based overseas, by forcing them to register with Customs.

Proposal 4 Use of trend analysis information

Customs to enhance the information available to its control staff by introducing trend analysis of the information obtained from monthly returns from excise warehouses, and so highlight unusual patterns of trade suggestive of fraudulent activity.

Proposal 5 The introduction of a movement document processing device

Customs and trade to consider the introduction of a secure, approved device for processing movement documents for duty-suspended goods with the aim of eliminating the fraudulent provision of receipts to despatching warehousekeepers.

Proposal 6 Registration and control of transporters

Greater control of transporters involved in duty-suspended movements by Customs introducing a registration process for this class of operator, and by warehousekeepers providing relevant information to Customs about transporters taking goods from their warehouses.

Proposal 7 Placing officers in "high risk" warehouses

Warehousekeepers to co-operate fully with Customs in the increased use of "invigilation" exercises at warehouses known to be used by suspected fraudsters, in the knowledge that there will be a major deterrent effect.

Proposal 8 Greater use by Customs of Administrative Accompanying Document (AAD) copy 4

Customs to improve their knowledge of inward duty suspended movements from other EU member states by asking the trade to send them copy 4 of administrative accompanying documents in line with any guidelines or parameter deemed necessary.

Proposal 9 Warehousekeepers to provide information about expected arrivals

Warehousekeepers to co-operate with Customs to provide details about booked arrivals of excise goods and to advise them of non-arrivals, thus indicating potentially fraudulent activity.

Proposal 10 Notification of cash transactions

Traders to notify Customs of any proposed payment for goods or services in cash contrary to normal commercial practices in order that Customs may better assess the risks of fraudulent movements occurring.

Proposal 11 Registration or licensing of alcohol dealers and retailers

Customs to use alcohol licensing or registration provisions to deal with dealers and retailers trading in illicit excise goods by depriving them of their licence or registration, thus reducing the outlets for fraudulently obtained goods.

Proposal 12 Extended use of bar coding technology to enhance traceability

The industry to continue to refine and adopt bar coding technology for the packaging of alcoholic products to enable goods to be traced back to source and in doing so enhance the information available to Customs.

Proposal 13 Endorsing invoices with duty payment details

Customs to improve their ability to trace goods back to duty payment by considering the introduction of requirement for invoices for the sale of excise goods to contain information as to where and how duty was paid.

Proposal 14 Improved intra EU mutual assistance

The trade endorses the review of the mutual assistance arrangements designed to radically improve the detection of fraud by speeding up the handling of references for suspect movements between member states.

Proposal 15 The Excise warehouse approval project

The trade endorses this Customs project, believing that it will lead to greater consistency of education amongst warehousekeepers about their obligations and responsibilities and so improve their awareness of potential fraud.

Proposal 16 The accreditation of excise warehousekeepers

The trade proposes that a worthwhile method of ensuring greater professionalism and awareness amongst excise warehousekeepers is to introduce a system of accreditation, possibly similar to systems of qualification used in other transport and logistics industries.

Proposal 17 The role of the JSFTF, the new JWFTF, and Memoranda of Understanding

The trade is committed to ongoing dialogue in the Joint Spirits Fraud Task Force, is setting up the new Joint Warehousekeepers Fraud Task Force, and is actively engaged in creating Memoranda of Understanding with Customs to underpin other initiatives.

27. We appreciate that the industry have made good efforts to put forward constructive proposals and this, in turn, has been accepted by the Government. However, the industry had been aware of the growing concern of HM Customs and Excise for some time, and it would have been helpful if the industry had responded quicker, and had been prepared to accept binding regulations, rather than rely on a code of voluntary agreements. Evidence from the Scotch Whisky Association did, we believe, illustrate a certain lack of urgency on the industry's part:

“The proposals which the Chancellor and Customs & Excise were proposing to us two years ago in a consultation exercise were a result of very high levels of fraud in the period between '95 and '98...That then led to the consultation, which went on to the whole process of the seven proposals which were put to the industry and trade and open to formal consultation. We replied to them and they came back to us. Right up until last October we were negotiating on a process to not go down some of the conclusions which Customs & Excise and the Government and Treasury offered us but to offer alternatives. We finished up negotiating but not signing or implementing, yet, a memorandum of understanding between the producers and Customs & Excise which was to tackle the whole question of the areas where the risk was most and where that risk was the highest. That was the basis on which we were negotiating with the authorities to find out how we could tackle fraud in the wake of the 1998 troubles. Suddenly out of the blue we come back to the proposal for tax stamps which, of course, the Chancellor in his 2002 Budget Statement had said was not the answer because the compliance costs for industry were too high...”²⁴

28. We are concerned also that the industry should maintain its guard against complacency. For example, during our confidential briefing, Customs and Excise told us of a situation whereby they had advised a recognised producer of spirits that they had evidence of diversion carried out by a distributor that the producer was using; the producer's response was that, as far as they were concerned, the distributor was legitimate, and they did not appear to take any action over the warning from Customs and Excise.

29. The Government's responses to each of the industry's proposals are set out at some length in the RIA,²⁵ and are not, therefore, rehearsed in this Report. Suffice it to say that, with the exception of Proposal 9, *Warehousekeepers to provide information about expected arrivals*,²⁶ the Government do not consider any of the industry's alternatives to have particular merit, and consider strip stamps to be a better option.

30. We do not know how exhaustive the Government's consideration of all these options has been, but its responses are disappointingly negative and unimaginative. For example, Proposal 12, *Extended use of bar coding technology to enhance traceability*, could have been considered in parallel with a recent EC Regulation²⁷ which, with effect from 1 January 2005, will mean that all food sold within the EU will need a barcode to ensure, *inter alia*, the traceability of food²⁸ (including alcohol). Although we understand that the rationale

²⁴ Q5

²⁵ RIA, *op cit*, pp 59-71

²⁶ *ibid*, pp 67-68

²⁷ Regulation (EC) No 178/2002 of the European Parliament and of the Council of 28 January 2002

²⁸ *ibid*, Article 18

behind this Regulation was to trace genetically modified product, we consider that there is the possibility of utilising modern technology to trace a bottle of spirits from distillery to shelf in the same way. We accept that it may be a few years before this particular technology is available,²⁹ but during our discussions in Washington we were advised of some interesting developments in combating tobacco fraud in California.³⁰

31. During our visit to Scotland, referring to the Government’s rejection of the industry’s proposals, we were asked, in effect, by one of the distillers “What more does the industry have to do in order to avoid the imposition of the strip stamp?” We put this to the Economic Secretary, but his response was, to be blunt, pretty unhelpful:

“The Chancellor was very clear in the Pre-Budget Report in December. It was an invitation to the trade and we worked with the trade where we could as well, to come up with an alternative or a set of alternatives which would have a similar impact on the levels of fraud which we face in the UK. If they could do that, then that for us would be a viable alternative to proceeding with tax stamps. They worked really hard at that and I pay tribute to the work they have done, but frankly the package of proposals unfortunately did not pass muster.”³¹

32. Mr Healey gave no indication as to the sort of proposals the industry could make that would pass muster.

5 The American system

33. During our discussions in Washington we were advised that, since tax stamps on spirits were abolished in the early 1980s, the United States operated a closed supply chain. Everyone in that chain, producer or importer, wholesaler and retailer, were licensed in the “three-tier system” of distribution. These tiers are:

- *Producer or importer* - The producer is the distilled spirits plant . They are required to obtain a permit, bond, maintain required records and are subject to numerous other regulatory requirements. They are the top of the three- tier system and pay the Federal excise tax after removal from their bonded premises. The importer is the functional equivalent of the producer for imported spirits, as the original source of these goods in the United States. The importer is liable for the excise tax on imported spirits and must pay the tax upon removal from the first Customs bonded warehouse.
- *Wholesaler* - wholesale liquor dealer. The wholesaler is the customer of the distilled spirits plant or the importer and the second level in the tier. The wholesaler is required to obtain a Federal permit, but the wholesaler is subject to very few Federal record keeping, or other regulatory requirements. Under current law, all Federal taxes have been paid on the distilled spirits products which are received by a wholesaler. Some producers and importers also conduct wholesale operations.

²⁹ See Q306

³⁰ Q356

³¹ Q360

— *Retailer* - liquor stores, restaurants, etc. No Federal permit required, but retailers do pay Special Occupational Tax. Like the wholesaler, Federal excise taxes have already been paid on products received by the retailer.

34. Such a system seems to work well in the US and, we assume, provided the model for the industry's Proposal 11, *Registration or licensing of alcohol dealers and retailers*. Although Customs do seem to have, at least, taken notice of this Proposal, it is only in the context of strip stamps actually being introduced, not as a measure in its own right.³² We consider that the introduction into the UK of a licensing regime along the lines of the American system certainly merits more thorough consideration by Customs, although we do appreciate that the European Single Market would preclude an exact parallel being introduced into the UK, in particular, and the EU as a whole.

6 Reassuring the public

35. The Government has set great store by retailers and consumers being able to tell whether the whisky being sold to them is legitimate. For example, in the RIA it is stated that:

“...unlike tax stamps, none of the (industry's) proposals, either individually or as a package, removes one of the pillars on which most diversion fraud is built – the ability to deceive honest traders and consumers that product is duty-paid when it is not...”³³

and continues:

“It will be significantly easier to identify those selling illicit product following the introduction of tax stamps. Tax stamps will mean that retailers and the public will know that they were purchasing illicit product and will be conscious of the potential risks associated with the purchase and consumption of illicit product.”³⁴

In oral evidence, the Economic Secretary to the Treasury expanded on this by saying:

“Essentially the prospect of tax stamps frankly kicks the legs out from underneath the fraudsters, both on the demand side and the supply side. On the demand side it will ensure that consumers and indeed retailers and wholesalers in the chain at the moment, will have an immediate and very clear visual sign that the product they are buying is indeed duty paid. They do not have that at the moment. What it means then is that any retailer or any trader cannot claim unknowingly to be dealing with product which does not have duty paid....The second thing is on the supply side. It would be impossible for a would-be fraudster to convince an honest alcohol trader, which they can at the moment, that they are dealing in duty paid goods if there is no stamp on them. What it means also therefore is that it will be much more difficult for the retailer to claim to Customs that they bought the goods believing the duty paid element was incorporated. In other words it would be much easier for Customs

³² RIA, *op cit*, p 70

³³ *ibid*, p 28

³⁴ *ibid*, p 30

then to nail and to prosecute traders and retailers who could not claim that they were trading without knowing that the product was not duty paid.”³⁵

36. We fear that the Government may be missing the point. An individual who buys a bottle of spirit from a large retailer, such as a supermarket or a branch of an off-licence chain, will reasonably expect the content of that bottle to be genuine, and that all relevant duties and taxes had been paid on it. But, if that same person were to buy a bottle of spirit from a boot sale or from “someone they met down the pub”, it is a fair chance that the purchaser would have some suspicion that the spirit had been stolen, smuggled or was fake.

37. In the same vein, if the proprietor of a corner shop or an off-licence buys spirit from “a white van man” who turns up at the proprietor’s backdoor with a few cases in the back of his vehicle, it is a very different proposition to buying goods from a reputable distributor or wholesaler. We consider that many people buying spirits under such circumstances must suspect that they are buying illicit goods. The fact that the bottle of spirit being offered for sale does not have a strip stamp will not, we suggest, deter most of them.

38. What, we believe, would deter people from buying and selling illicit spirits is the prospect of detection and prosecution. When the Economic Secretary appeared before us, we raised with him the possibility of using section 170A of the Customs and Excise Management Act to recover civil penalties from those convicted of offences involving non-duty paid goods or, if necessary, changing the law to facilitate the prosecution of such individuals.³⁶ Mr Healey was non-committal, although he did say:

“...Part of the discussion we shall have within this House during the passage of the Finance Bill and then subsequently in any regulations which bring the tax stamp regime into place will be about the appropriate level and regime for penalties which need to be put in place to underpin the tax stamps regime. That is an issue I know we are going to be debating.”³⁷

39. We see no reason why such a debate on the level and regime for penalties needs to be undertaken in order to underpin a strip stamp regime only; we consider that such penalties could speedily be introduced as an alternative to tax stamps.

40. Evidence was obtained from officials of HM Customs and Excise, in both formal evidence and at a confidential briefing attended by the Committee. We were concerned that Customs appeared to be reluctant to prosecute retailers and others supplying spirits on which duty had not been paid.³⁸ Given the terms of existing legislation, that is not unreasonable; but it does not, however, explain their failure to consider possible changes to legislation. It was apparent that no proper consideration had been given to the introduction of a strict liability offence of selling or supplying alcohol on which duty had not been paid, to which a defence of due diligence could be made. The prosecution of

³⁵ Q330

³⁶ QQ378-385

³⁷ Q381

³⁸ Q378

retailers in these circumstances might make it easier to identify these in the supply chain responsible for fraudulent diversion.

41. Should the Government insist that the public needs some kind of visual indication that duty has been paid on a bottle of spirits, we believe that it would be far less disruptive to the industry for a tax stamp to be incorporated into the front or the back label of a bottle. We accept that there would still be extra security costs for the industry, as the labels themselves would be worth £5.48 per each 70cl bottle,³⁹ and the duty would still need to be paid “upfront”, but there would not be the potential extra cost of having to buy new bottling machines – which, as we noted in paragraph 19, could cost in excess of £1million.

7 Conclusion

42. We wish to put it on record that we support fully the Government’s and the industry’s attempts to tackle spirits fraud. However, as we say in paragraph 16 above, the Government appears to be reacting in response to what is an unconfirmed level of fraud, with the possibility of major implications for the industry. In addition, for the reasons we set out in paragraphs 17 – 24, we are convinced neither that strip stamps would be the best way to tackle such fraud, nor that the Government has exhausted all possible alternatives. Under such circumstances, the Committee urges the Government to reconsider Clause 4 of and Schedule 1 to the Finance Bill.

³⁹ About £7.50 on a litre bottle

Formal Minutes

Thursday 22 April 2004

Members present:

Mrs Irene Adams, in the Chair

Mr Alistair Carmichael
Mr David Hamilton
Ann McKechin

Mr Mohammed Sarwar
Mr Michael Weir

The Committee deliberated.

Draft Report [The Proposed Whisky Strip Stamp], proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1-42 read and agreed to.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 134 (Select Committee (reports)) be applied to the Report.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

[Adjourned till a date and time to be fixed by the Chairman]

Witnesses

Wednesday 3 March 2004

Page

Mr Ian Good, Mr Gavin Hewitt and Mr Campbell Evans, Scotch Whisky Association

Ev 9

Tuesday 9 March 2004

Mr David Hubbard, Mr Derek Hodgson and Mr Tony Walker, HM Customs and Excise

Ev 25

Tuesday 16 March 2004

Mr Stuart Thomson, Ardbeg Distillery, **Mr Andrew Rankin**, Bowmore Distillery, **Mr Simon Coughlin** and **Mr David Barr**, Bruichladdich Distillery and **Mr Anthony Wills**, Kilchoman Distillery

Ev 44

Thursday 1 April 2004

Mr Andy Colvin, Sainsbury, **Mr Chris Lonergan**, PricewaterhouseCooper, **Mr Howard Winn**, Sainsbury and **Mr Quentin Rappoport**, Wine and Spirit Association

Ev 54

Mr John Healey MP, Economic Secretary, HM Treasury and **Mr Nigel Pearce**, HM Customs and Excise

Ev 66

List of written evidence

The Scotch Whisky Association	Ev 1
Spectroscopic and Analytical Developments Ltd	Ev 80
CBI Scotland	Ev 80
HM Customs and Excise	Ev 20
HM Customs and Excise	Ev 23
Scottish Trades Union Congress	Ev 81
The Scottish Council for Development and Industry	Ev 82
The Chairman of the Committee	Ev 62
HM Treasury	Ev 63
HM Treasury – Mr John Healey MP	Ev 64

List of unprinted written evidence

Additional papers have been received from the following and have been reported to the House but to save printing costs they have not been printed and copies have been placed in the House of Commons library where they may be inspected by members. Other copies are in the Record Office, House of Lords and are available to the public for inspection. Requests for inspection should be addressed to the Record Office, House of Lords, London SW1. (Tel 020 7219 3074) hours of inspection are from 9:30am to 5:00pm on Mondays to Fridays.

The Gin and Vodka Association (on behalf of the Joint Alcohol and Tobacco Consultation Group)

Publications from the Scottish Affairs Committee since 2001

The following publications have been produced by the Scottish Affairs Committee in the 2001 Parliament:

Session 2003-04

First Report	Coincidence of Parliamentary Constituency Boundaries in Scotland and the Consequences of Change	HC 77
Second Report	Work of the Committee in 2003	HC 344
First Special Report	Response by the Government to the First Report (Session 2003-04) on Coincidence of Parliamentary Constituency Boundaries in Scotland and the Consequences of Change	HC 514
Minutes of Evidence	Registration of Voters in Scotland	HC 78-i

Session 2002-03

First Report	The Work of the Scottish Affairs Committee in 2002	HC 197
Second Report	Homeworkers and the Minimum Wage	HC 335
First Special Report	Scotland Office Expenditure	HC 198
Second Special Report	Response by the Government to the Fifth Report (Session 2001-02) on Employment in Shipbuilding on the Clyde	HC 199
Third Special Report	Response by the Government to the Second Report (Session 2002-03) on Homeworkers and the Minimum Wage	HC 816
Minutes of Evidence	Futureskills Scotland	HC 101-i
Minutes of Evidence	The Work of Citizens Advice Scotland	HC 158-i
Minutes of Evidence	The Work of the Disability Rights Commission in Scotland	HC 608-i
Minutes of Evidence	The Work of the Child Support Agency Centre in Falkirk	HC 693-i
Minutes of Evidence	Job Creation Potential of the Modernised Forth, Clyde and Scottish Union Canal	HC 717-i
Minutes of Evidence	Custom Services in Scotland	HC 911-i
Minutes of Evidence	Scotland Office Departmental Report 2003	HC 815-i

Session 2001-02

First Report	The Drinks Industry in Scotland	HC 324
Second Report	Job Creation Potential of the Modernised Forth, Clyde and Union Canal	HC 424
Third Report	Post Devolution News and Current Affairs Broadcasting in Scotland	HC 549
Fourth Report	Customs Services in Scotland	HC 782
Fifth Report	Employment in Shipbuilding on the Clyde	HC 865

First Special Report	Response by the Government and the Scottish Executive to the First Report (Session 2001-02) on the Drinks Industry in Scotland	HC 696
Second Special Report	Response by the Government to the Fourth Report (Session 2001-02) on Customs Services in Scotland	HC 1287
Minutes of Evidence	Scotland Office Departmental Report 2001	HC 345-i
Minutes of Evidence	The Work of the Commission for Racial Equality in Scotland	HC 712-i
Minutes of Evidence	The Work of the Scottish Consumer Council	HC 1199-i

Oral evidence

Taken before the Scottish Affairs Committee on Wednesday 3 March 2004

Members present

Mrs Irene Adams, Chairman

Mr Alistair Carmichael
Mr Peter Duncan
David Hamilton
Mr John Lyons

Mr John MacDougall
Ann McKechin
Mr Mohammed Sarwar
Mr Michael Weir

Memorandum submitted by The Scotch Whisky Association

1. INTRODUCTION

1.1 The Scotch Whisky Association is the trade body which represents the interests of the industry at home and abroad. Its main objective is to promote and protect the Scotch Whisky industry.

1.2 The 57 member companies of the Association account for more than 95% of the Scotch Whisky sold worldwide.

1.3 Scotch Whisky production is of crucial importance to the economy of both Scotland and the UK as a whole.

1.4 A study by DTZ Pidea Consulting, "*The Economic Impact of the Production of Scotch Whisky, Gin and Vodka in Scotland*", published in January 2003, concluded that over 10,000 people are directly employed in Scotch Whisky production. In total, some 41,000 jobs in Scotland and 65,000 jobs across the UK are indirectly supported by Scotch Whisky production. Many of these jobs are in economically fragile rural areas and disadvantaged urban areas.

1.5 In addition to the £800 million contributed annually through excise duty and VAT payments, the industry has contributed in excess of £2 billion a year to the UK balance of trade for the last ten years. Annually, over £800 million of income (wages and salaries) is generated in Scotland and distillers spend over £1 billion with UK suppliers of goods and services.

1.6 Maintaining the competitiveness of the Scotch Whisky industry at home and abroad is of fundamental importance to supporting employment and the wider economy.

2. BACKGROUND

2.1 In the December 2003 Pre-Budget Report, the Chancellor of the Exchequer proposed the introduction of legislation in the 2004 Finance Bill requiring tax stamps on bottles of spirit drinks in the UK from 2006, as a measure to combat spirits fraud.

2.2 Scotch Whisky producers have long been resolutely committed to tackling the problem of spirits duty evasion and wish to work even more closely with Customs & Excise in so doing, building on existing collaboration. Spirits fraud undermines distillers' business and brand building efforts, as well as government revenue.

2.3 However, the industry does not believe that tax stamps are an appropriate or proportionate solution. The introduction of tax stamps on whisky bottles would add considerable costs to the supply chain, reducing competitiveness and productivity, whilst doing little to tackle spirits fraud. Indeed, it would open up new avenues for fraud through the counterfeiting of tax stamps.

2.4 The Scotch Whisky Association welcomes the Committee's inquiry, and the opportunity to provide evidence to it.

3. ALTERNATIVE SOLUTIONS TO TAX STAMPS

3.1 In the Pre-Budget Report, the Chancellor of the Exchequer stated that he would legislate for tax stamps on spirit drinks unless the spirits industry was able to bring forward proposals for tackling spirits fraud that would be as effective as the government believed would be achieved by tax stamps.

3.2 The Scotch Whisky industry, working closely with all interested parties across the alcoholic drinks distribution chain, has developed a forward-looking package of alternative proposals (see Annex). These proposals strike where action against fraud will be most effective—directly at the fraudster and focused on the areas of the highest risk of fraud. By contrast, tax stamps would be a blunt instrument and ineffective.

3.3 The industry's package of alternative proposals offer a number of clear advantages to the introduction of tax stamps and would result in:

- More revenue gain for HM Treasury than tax stamps. The industry's package of measures could remove at least 50% of spirits fraud. (Tax stamps are only expected by Customs & Excise to halt 27%.)
- Faster implementation than tax stamps and delivery of an earlier revenue gain—by the end of FY 2004–05. (Tax stamps would not be in place before FY 2006–07.)
- More enduring effectiveness due to their robustness and multi-faceted nature. Tax stamps have been shown overseas to have limited effectiveness and will quickly be forged.
- A more proportionate response to fraud levels, which industry figures show to be lower than Customs & Excise estimates and to be falling.

The proposals can be summarised as follows:

3.4 A tighter system of **financial guarantees** would be introduced. All diversion fraud takes place during the movement of spirit drinks. Without an excise guarantee, there can be no movement of spirits. As such, warehousekeepers would not provide a guarantee for high-risk movements when the person owning or moving the goods was not bona-fide. The trade could introduce the new system as best practice in 2004 (ahead of changes in regulations), forcing fraudsters into the guarantee system or out of business. As a fraudster is unlikely to survive the financial scrutiny necessary to obtain a guarantee, the industry believes this measure alone effectively stops outward diversion (over 50% of fraud level).

3.5 The industry would seek early implementation of the already negotiated, but not yet signed, industry/government **Memorandum of Understanding**. This introduces notification of new customers and other movements and transactions fitting risk profiles, and a wide range of mechanisms to assist Customs & Excise with detailed information about supply routes and end customers.

3.6 The industry would welcome increased collaboration via the existing **Joint Spirits Fraud Task Force** (JSFTF). This group was set up following the decision not to proceed with tax stamps just two years ago and has improved government and trade co-operation and success in tackling spirits fraud. This partnership could be extended to assist Customs & Excise's ability to tap into industry expertise in identifying and tracking illicit spirits. "Fast track" contact details can, for example, be provided for all investigations, to identify sources of illicit supply. Customs & Excise can call up producers to assist in tracing where fraud has occurred. Since the system was established in 2002, the industry has been surprised at the low number of calls received from C&E given the claimed level of fraud.

3.7 Building on the success of the JSFTF model, and embracing an important link in the supply chain and the front line fight against fraud, the independent bonded warehousekeeping sector is offering to establish a new **Joint Warehouse Fraud Task Force**, with early implementation of a new warehousekeepers/ government Memorandum of Understanding. Improved approval, control and analysis of warehouse stocks, movements, sales and ownership of goods would quickly identify and target high-risk or illicit transactions.

3.8 Also in the warehousing sector, where abuse of innocent warehouses by fraudulent owners of goods tends to occur, better identification by Customs & Excise of risk and unusual trends could be achieved through the **improved use of warehouse returns** now being submitted by the trade. Customs & Excise will have systems to analyse the returns in place by mid-2004. This will be assisted by the rigorous **review of warehouse approvals**, and cancellation in cases of irregularity. **Professional accreditation and better training** of warehousekeepers should also be introduced and Customs assurance officers might also be placed in the highest-risk warehouses, which are small in number. This would fit neatly with Customs & Excise own preferred operating method: establish the normal, challenge the abnormal, and, to improve efficiency, concentrate their resources on a risk-based approach.

3.9 The Scotch Whisky industry is committed to working with the government towards the early implementation of a number of new initiatives, largely set out in Customs & Excise's December 2003 responses to its consultation on "*Excise—Reducing opportunities for alcohol fraud*", such as the introduction of a "**recognised transporters**" scheme, as well as the fuller use of a number of other recent Customs & Excise controls and **databases**.

3.10 All businesses selling spirits throughout the supply chain would require **licences**. Tighter Customs & Excise links to the licensing of all wholesalers and retailers would cut off fraudsters' markets for illicit supplies; infringement could lead quickly to loss of licence.

3.11 The industry believes it would be helpful to introduce the use of existing **technology** to uniquely number and process movement documentation. A secure device, for example, for uniquely stamping documents is already in use in France, and is said to have had a significant impact in preventing inter-warehouse fraud. This machine would counter the use of forged signatures and stamps on documents. Extended use of bar coding technology and lorry tracking to enhance traceability will also be examined.

3.12 In the medium term, Scotch Whisky producers are fully supportive of the development of the electronic **EU Excise Movement and Control System** and we will co-operate in its design, development and implementation. This EU-wide scheme, which is due to come into operation in 2009, ie just three years after the proposed date for tax stamps, should be at the heart of a secure and efficient supply chain. It should also be backed up by enhanced co-operation between different EU Member States on cross-border movements which will help clamp down on fraudulent trade.

3.13 Underpinning the above, it is essential that there is improved spirits **industry/Customs & Excise partnership**, on a privileged basis if necessary, to identify fraud as it happens, to target assurance resources where fraud is most prevalent, such as high risk owners, sales and movements at high risk warehouses, and to build on existing success in tackling inward diversion. Regular access to Queen's Warehouses should be considered to allow producers to inspect seized stock and help identify the methods and routes of the illegitimate trade.

3.14 The industry believes that this basket of measures, drawn up with the benefit of market experience, will prove more effective, more quickly than tax stamps, that will damage legitimate traders, while only offering limited effectiveness in combating the fraudster.

4. SPIRITS FRAUD ESTIMATES

4.1 The industry has significant reservations about the suggested level of fraud taking place.

4.2 Customs & Excise estimates that £600 million of revenue was lost in 2001–02 due to spirits fraud. It is on this basis that the tax stamps proposal is founded.

4.3 The Scotch Whisky Association believes the Customs & Excise figures are at odds with other government and commercial data, and that they significantly overestimate fraud levels. Instead, we believe joint government and trade activity is succeeding in driving fraud downwards, and that additional action would result in further detections.

4.4 The industry's concerns can be summarised as follows:

- If the government estimate is correct, £1.6 million of revenue would be lost, or 200,000 illegally traded bottles would be sold every day.
- The industry recognises that fraud does take place (see 4.6) and that illicit stock will be found in some areas. However, we do not believe it is credible to suggest, as the Customs & Excise estimates suggest, that almost *every* bottle of spirits in *every* independent shop (ie not supermarkets, multiple off-licence chains or Co-ops) in the UK is fraudulent. Many are supplied by reputable wholesalers with equally effective controls and distinct supply chains similar to the supermarket and multiple sectors, and who pay duty on clearing the goods.
- In 1997–98, the level of fraud was such that the legitimate trade saw significant disruption to the supply chain. Trade action groups, particularly in the producer and wholesaler sector, took steps to work with government successfully to isolate the fraudsters. Today, no-one in the trade sees the market disruption that would result from fraud on the scale suggested by the C&E figures.
- Customs & Excise figures imply a 50% increase in total spirits consumption since 1992–93. To suggest such growth to spirits producers is met with disbelief and we are not aware of any other government or commercial data on the UK drinks market which can corroborate such significant growth.
- In December 2003, the government published fraud estimates for the three fiscal years up to 2001–02. If fraud was increasing over this period, it is likely that this would be revealed by flat or falling legitimate spirit clearances. Yet clearances have risen significantly in each of the three years, and 2001–02 were 16.5% higher than 1998–99. Just published clearance figures for 2003 show that clearances have risen every year since the trough of 1997–98, when fraud was known to be a high level. Since that period clearances are up 31%, yet Customs & Excise are suggesting that the illicit trade gap has been growing even faster on top of this very healthy clearance trend.
- When first published, Customs & Excise estimates of spirits fraud in 1999/2000 were £450 million. Last year these 1999–2000 estimates were increased to £500 million. In December 2003, the figure dropped to £350 million, yet Customs & Excise have consistently claimed their methodology is robust, notwithstanding that, in the case of wine and beer, the same gap analysis methodology has proved unreliable and been dropped for the purposes of assessing the level of wine and beer fraud. It is difficult, in the light of the ever-changing 1999–2000 figures, not to have doubts over the latest estimate of fraud.

- Customs & Excise's methodology is complex and involves a series of assumptions and calculations, several with scope to introduce margins of error. In looking forward to 2006–07, it also assumes that, irrespective of joint Customs & Excise and trade success in tackling fraud, the illegal market will remain at 16% of consumption, prior to the apparent panacea of tax stamps.

4.5 Industry gap analysis, based on other data from government (ONS) drinking surveys, suggests the level of fraud has been *reducing* since the peak in the mid-1990s, reflecting the success of government/trade anti-fraud measures, and increasing levels of detection.

4.6 By these alternative estimates, the revenue loss from illicit spirits trade has fallen from £250 million in 1999–2000 to c.£100m–£150 million in 2001–02, ie it is only a quarter of the estimate on which the tax stamps proposal is based.

4.7 The National Audit Office's consideration of the differing views on the existing level of spirits fraud will assist in providing a base from which appropriate proposals for tackling fraud can be determined. Depending on its findings, these proposals can be assessed for their proportionality and compliance costs on legitimate traders.

5. COMPLIANCE COSTS AND COMPETITIVENESS

5.1 The Scotch Whisky industry believes distillers will face disproportionate costs, running into tens of millions of pounds, to introduce tax stamps.

5.2 Customs & Excise has estimated that the compliance costs of tax stamps for spirit drinks would be approximately £45 million in the first year (including £30 million in set-up costs) and £15 million per year thereafter. These estimated compliance costs are based on incomplete information. They underestimate both the costs to industry and the impact of tax stamps right through the supply chain. They are based on the previous 2001–02 consultation on tax stamps and focus solely on some producer figures rather than the full supply chain that also incorporates warehousekeepers, importers, distributors, wholesalers, and retailers.

5.3 The Pre-Budget Report announcement recognised there would be significant compliance costs and indicated that measures would be considered to mitigate these. It is impossible to provide a fully costed impact assessment at this stage because Customs & Excise has not indicated the precise way in which the tax stamps scheme would operate. However, a compliance cost analysis prior to any mitigating offsets, shows the cost across the supply chain to be running at c.£23 million of capital expenditure, plus annual on-going costs in excess of £60million. Whatever system of mitigating costs are brought forward, it is unlikely to compensate for all the costs, lost efficiency and reduced productivity. It is likely to create winners and losers; with some of those in the SME sector least able to meet the increased costs the biggest losers.

5.4 Careful consideration would need to be given to any proposed changes to either duty deferment accounts or the duty deferment period to ensure that there is no distortion of competition in the market.

5.5 Depending on the duty deferment scheme proposed, distillers and importers could still face significant cash flow problems as a result of having to finance the purchase of tax stamps up front, including interest payments, weeks before the stock is sold to customers.

5.6 High compliance costs will hit distillers, bottlers, warehouse operators, importers, wholesalers, high street retailers, and shops in the travel retail sector. Insufficient assessment has yet been made of the wider impact of tax stamps.

5.7 The industry is extremely concerned about the impact on the security of company operations. Extra security costs and procedures for handling stamps, each worth £5.48 in excise duty for a 70cl bottle of whisky, will need to be introduced. Bank style security will be required at printers, cutters, dry goods stores and bottling stores. The total value of UK tax stamps at a large bottling plant at any one time is likely to be higher than the cash in local banks.

5.8 The incentive for theft and counterfeit will be increased. Bottles bearing tax stamps will be more attractive to thieves, thus increasing the risk of stolen lorries. The stamps also have a potentially negative impact on the generally very good employee relations that exist in the industry at present. Because stamps are small and easy to conceal, companies are alarmed at the human resource implications if it proves necessary to tighten up on existing searches of personnel leaving bottling plants. All these risks will inevitably add to insurance costs, with some smaller producers already expressing concerns that insurers will not be prepared to provide cover for the increased risk.

5.9 Paper stamps add another complex step into the packaging process, reducing efficiency on bottling lines by an 8–10% 'rule of thumb' average. Smaller companies operating older machines will find efficiency reduced to an even greater degree. In many cases, due to the size of the UK market, there will be insufficient capacity available on existing machines. Companies will need to buy new application machinery, which can only be sourced from overseas. Damaged or misapplied stamps will need to be collected, reworked and reclaimed due to their duty value.

5.10 Tax stamps will have a disproportionate impact on smaller companies that rely more heavily on the UK market, as well as on smaller brands and bottling runs. A crucial element is the additional capital expenditure required and the cash flow implications, subject to any revised deferment scheme that is

introduced, resulting from the likely requirement to purchase tax stamps weeks before stock is sold. Concern has been raised that the additional costs will make some spirit sales uneconomic, thereby leading to brands disappearing from the UK market, thus reducing competition and consumer choice.

5.11 Due to the likely design of tax stamps, all spirit drinks for sale in the UK will become unique stock keeping units. This reverses industry efforts to minimise complexity and utilise multi-market packaging. Among other things, UK-specific stock will require increased warehouse space, create the need for more frequent bottling line changeovers, and could require products to be redesigned. Tax stamps reduce stock flexibility, damage productivity and competitiveness, and add complexity to the supply chain.

5.12 Bottling plants will have to deal with a proliferation of tax stamps of different values. While most Scotch Whisky in the UK is bottled at 40%abv, some brands bottle at 43%abv or 47%abv. And, there are cask strength bottlings, the strength of which is not known until bottling, making it impossible to order tax stamps in advance, even assuming a stamp for a product of that alcoholic strength actually exists.

5.13 Given that Scotch Whisky only needs to be distilled and matured in Scotland, there is a possibility that the high compliance costs of tax stamps will force companies to look to reduce these increased costs in other ways by carrying out other aspects of the production process, such as bottling, in lower cost environments, even outside the UK. Undoubtedly, this would impact on employment in Scotland.

5.14 As noted above the government has said that it is prepared to consider ways in which to mitigate the costs to the legitimate trade. It has been suggested, for example, that financial assistance might be provided by government to offset capital costs. It is unclear whether financial assistance might also be available to bottlers outwith the UK. Any such aid, however, is likely to be open to challenge under EU state aid rules and may not be available equally to all companies in the sector, thereby distorting competition. A freeze on spirits duty is examined separately under section 7 below.

5.15 All these unwelcome effects reduce the competitiveness of Scotch Whisky and other spirits, and are not compatible with the government's wider agenda of encouraging improved productivity and competitiveness, and a reduction in red tape.

6. INTERNATIONAL PERSPECTIVE

6.1 Scotch Whisky is exported to 200 countries around the world giving distillers unparalleled experience of the impact and effectiveness of regulation in the spirits sector.

6.2 The industry's experience is that high quality forgeries of tax stamps appear quickly and become common. With UK excise duty at £5.48 per 70cl bottle of Scotch there would be a strong incentive for forgery, and the creation of a new counterfeiting industry.

6.3 A recent example was the Ukraine's decision to reformulate its tax stamps system on 1 January 2004 in an effort to defeat widespread fraud of existing stamps. Within three weeks, we understand the Ukrainian police had reported the seizure of 66,000 bottles of illicit spirits each marked with forgeries of the newly introduced state of the art hologram seals.

6.4 Despite the use of tax stamps, industry experience is that roughly 15–20% of the market in Hungary remains illicit and around 80% of Scotch Whisky sold in Poland is understood to be contraband. Around 60% of the spirits market in Bulgaria does not pay excise duty despite tax stamps.

6.5 The experience in Mexico has been that tax stamps have done little to tackle the illegal market, which is thought to have expanded by roughly six times in the last ten years, and large numbers of fake stamps are being used to give illegal product the appearance that it is duty paid.

6.6 Several countries have either abolished their tax stamp regime (Ecuador, Greece, USA) or pulled back from introducing them (Belgium, Germany, Norway) due to their limited effectiveness. Within the EU, both Denmark and Portugal have discontinued their use on fortified wines. Indeed, when discarding stamps in 1986 the USA (Department of Treasury) noted: ". . . *The stamps only have negligible value in evidencing compliance with the law and payment of excise taxes. . .*"

6.7 In the case of Norway, tax stamps legislation was adopted in 1997. However, the Norwegian government pulled back from its implementation following a recognition of the technical complexities involved and representations from, among others, the UK Department of Trade and Industry. The DTI noted at the time that the Norwegian system: ". . . *would constitute a barrier to trade for the following reasons . . . They would discriminate against imported alcoholic beverages . . . are likely to be inefficient and ineffective as a means of combating fraud and illicit trade; . . . are disproportionate and conflict with the principle of the free movement of goods; . . . will cause many practical and technical problems in respect of, for example, labelling and storage of alcoholic beverages; and . . . will involve significant additional costs for the industry in fulfilling these requirements.*"

6.8 The evidence from Central and Eastern Europe is that genuine tax stamps can be used to disguise breaks in seals after re-filling and that unscrupulous traders use stamps to add authenticity to counterfeit product. There is evidence of Spanish tax stamps appearing on spirit drinks to add legitimacy to products being sold in the Philippines.

6.9 Notwithstanding this international experience of the ineffectiveness of tax stamps, there are fears that should the UK proceed to introduce tax stamps a damaging precedent will be set. Export markets look to the example of the UK and may seek to also introduce tax stamping regimes, increasing costs further, causing untold damage to international competitiveness.

6.10 With 90% of sales abroad, international competitiveness is crucial to Scotch Whisky. Every year for the last ten years, Scotch Whisky exports have contributed over £2 billion to the UK's balance of trade. Given the importance of international trade to the Scotch Whisky industry, there are concerns that if others did follow such a UK move the industry's ability to compete in the global market would be undermined.

6.11 Tax stamps will form a barrier to trade forcing distillers to produce and keep country-specific stock, increasing costs, reducing bottling line efficiencies and restricting flexibility. Increased use of tax stamps would, for example, fragment Scotch's largest export destination, the EU Single Market, which accounts for 40% of exports (£881 million in 2002).

6.12 Tax stamp regimes, currently found in only four EU Member States, might themselves be unlawful. An official at the European Commission has observed that the continued use of tax stamps in these countries may simply be a consequence of the regimes not having, as yet, been fully challenged.

6.13 A considerable amount of industry resources are devoted each year to challenging trade barriers in different markets around the world. The support of the UK government in this work is vital. There are concerns that industry efforts to challenge tax stamps systems overseas which discriminate against Scotch will therefore be hindered. This has already happened in Portugal where the British Embassy in Lisbon has indicated it will no longer be able to assist in pursuing the industry's case against the recent changes to the national tax stamps system, that were problematic for the Scotch Whisky industry.

6.14 Altogether, 40 different countries use tax stamps. However, it should be noted that approximately half require stamps to be applied in the market. Therefore there are around 20 countries that allow stamps to be applied in Scotland. Total exports to these markets represent only 20% of all Scotch Whisky sales. However, this figure is distorted by Spain, one of the industry's largest export markets, which alone accounts for 14% of exports. The remaining markets where tax stamps can be applied by bottling lines in Scotland therefore account for just 6% of all Scotch Whisky sales, and this figure is virtually all accounted for by Portugal and Italy. Other than Spain, no market of a comparable size to the UK requires tax stamps. In the case of Spain the value of each stamp is 3.75 times less than would be the case in the UK, thus inflicting considerably less cash flow disruption and security implications.

6.15 Of the 40 countries that require stamps, 23 introduced the regime during the 1990s. All of the countries that did so are developing economies. Of the developed countries that also considered stamps during this period, all rejected them.

7. EXCISE TAX

7.1 The Scotch Whisky Association has welcomed the duty freeze for spirit drinks over the last six years, as the steps have increased fairness in the taxation of alcoholic beverages and helped to bring stability to the home market.

7.2 The Association has also welcomed the government's 2003 Budget "*commitment to delivering a fairer balance in the burden of taxation falling on different alcoholic drinks and different types of drinks producer.*"

7.3 The government has indicated that it might be prepared to consider freezing spirits duty for the lifetime of the current Parliament to assist in mitigating the cost of tax stamps.

7.4 It is difficult to assess any benefit fully until the full extent of compliance costs and how the tax stamp regime would be run are known. However, an excise standstill does not provide instant support in paying off the cost of compliance, including the interest and capital borrowed to buy new machinery.

7.5 Econometric data shows that spirits are extremely price sensitive. A key determinant of price is of course the high tax burden. A duty reduction could therefore allow the trade to grow. For any benefit to be seen by the industry at large, however, would assume that any benefit would be passed back along the whole of the supply chain to the producer.

7.6 The Scotch Whisky Association therefore does not believe a freeze in spirits duty would adequately mitigate the cost of tax stamps. Indeed, the advice we have received from member companies, in particular smaller producers or those with a large exposure to the UK market who would be disproportionately hit by the compliance costs, is that a duty freeze would not offset the damage caused by the introduction of tax stamps.

7.7 The continuing high level of excise duty levied on Scotch Whisky and other spirit drinks in the UK is a major incentive and encouragement to individuals and groups to indulge in illegal activity. The action of Denmark in October 2003 to cut its spirit duty rate by 45%, and the 44% cut in spirits duty in Finland on 1 March 2004, were motivated by distortion of trade as a result of high tax levels. They are examples the UK should not ignore.

7.8 The position of the Association is further outlined in its 2004 Budget submission, "*Excise Duty: A Fair Measure for Scotch*". This calls for the Chancellor to implement a 4% reduction in spirits duty relative to other alcoholic drinks and take further steps with his policy towards a fairer balance in the burden of alcohol duty. This would benefit both HM Treasury and the industry, whilst also helping to remove the incentive for the fraudster.

8. CONCLUSION

8.1 Closer cooperation between the trade and Customs & Excise is the only way to tackle fraud effectively. Scotch Whisky producers are committed to fighting spirits fraud and working with the government to defeat the fraudster. We believe collaboration is already bringing benefits and that fraud is falling, and we are committed to driving it down further.

8.2 The industry is opposed to the introduction of tax stamps. Customs & Excise see them as a solution because they are visible. But fraud is a complex activity that requires a policy response that has direct impact upon the perpetrators. Stamps are limited in effectiveness, will impose significant and disproportionate compliance costs across the supply chain, and will damage the industry's competitiveness at home and abroad, while, on the basis of experience elsewhere, not reaching the heart of the problem and, most likely, opening up new avenues for illegal activity.

8.3 The Scotch Whisky Association has welcomed the opportunity to bring forward alternative proposals to tackle spirits fraud. We believe the Scotch Whisky industry and the wider alcohol trade have risen to the challenge set by the Chancellor and developed a forward-looking package of alternative proposals. These proportionate measures will effectively target the fraudster, rather than harming, as stamps would, legitimate producers, and could remove at least 50% of existing fraud. They will deliver more revenue to HM Treasury, more quickly than tax stamps.8.4 The Association would be delighted to discuss with the Committee any points raised in this paper on which the Committee may wish to seek further details.

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ANNEX—SUMMARY OF ALCOHOL TRADE ALTERNATIVE PROPOSALS				
<i>Proposal</i>	<i>Initiative</i>	<i>Benefits</i>	<i>Tackles Outward* Diversion</i>	<i>Tackles Inward* Diversion</i>
Implement Memorandum of Understanding with producers and importers	Implementation of already negotiated industry/ government MoU introducing restrictions on supplies of highest risk, notification of other movements fitting risk profiles, and assisting C&E with detailed information about supply routes and customers.	Targeting of resources on relatively small number of abnormal loads	Yes	Yes
Target high-risk owners, sales and movements	Improved approval, control and analysis of warehouse stocks, movements, sales and ownership of goods should pick up high-risk or illicit transactions very quickly.	Establish the normal, challenge the abnormal	Yes	Yes
Revised system of guarantees	No excise guarantee, no movement of spirits. No warehousekeeper's guarantee for high-risk movements.	New system as best practice in 2004 and stiff penalties would be imposed Fraudsters forced into the guarantee system or out of business. End to outward diversion.	Yes	No
New warehousekeepers' Memorandum of Understanding	Begin work on the early implementation of a new MoU with warehousekeepers	Partnership approach to target high risk warehouses	Yes	Yes
New Joint Warehouse Fraud Task Force	A new Joint Warehouse Fraud Task Force should be set up.	Sharing intelligence to tackle abnormal trade	Yes	Yes
Improved use of warehouse returns	Improved use by C&E of industry warehouse returns to identify better where risk lies and allow faster spotting of unusual trends.	C&E will have system in place by June 2004.	Yes	No
Review of warehouse approvals	Rigorous review of warehouse approvals, and cancellation if there is irregularity.	Removal from trade of unsuitable operators.	Yes	No

ANNEX—SUMMARY OF ALCOHOL TRADE ALTERNATIVE PROPOSALS—*(Continued)*

<i>Proposal</i>	<i>Initiative</i>	<i>Benefits</i>	<i>Tackles Outward* Diversion</i>	<i>Tackles Inward* Diversion</i>
Professional training and accreditation for warehousekeepers	Professional accreditation and better training of warehousekeepers.	Better awareness of trade and C&E requirements	Yes	Yes
C&E assurance officers in highest risk warehouses	C&E assurance officers placed in the small number of highest risk warehouses	C&E presence has been shown to halt unusual trades	Yes	Yes
Strengthened licensing system	C&E licences required by all businesses selling spirits.	Tighter C&E links to the licensing of all wholesalers and retailers will help to cut off fraudsters' markets for illicit supplies.	Yes	Yes
New machine for stamping documents	Introduction of a new machine to uniquely number and process movement documentation.	Would counter the use of forged signatures and stamps on documents.	Yes	Yes
Enhanced controls on transporters	Early implementation of new initiatives, such as the introduction of a 'recognised transporters' scheme, and the fuller use of a number of other recent C&E controls and databases.	Disrupts opportunities for diversion and encourages the transporter to take responsibility for ensuring correct delivery of load.	Yes	No
Better use of trade intelligence	Co-operation by producers within Joint Spirits Fraud Task Force has allowed C&E to tap into industry expertise in identifying and tracking illicit spirits. Far more can be made of this collaboration, including exchange of information on a privileged basis if necessary.	"Fast track" contact details provided for all investigations. Better use by C&E of trade contacts to identify the sources of illicit supply and routes to market. Producers can assist in tracking where fraud has occurred—even identifying where bottles have been removed. Facilitates targeting of resources in identified high risk areas.	Yes	Yes

*Outward Diversion is where the paperwork indicates that the goods are scheduled for export, but are diverted into the UK market and never leave the country. C&E figures indicate that this currently accounts for more than half of the revenue loss from spirits. *Inward Diversion is where imported goods do not reach the destination warehouse and again appear in the UK market.

Witnesses: Mr Ian Good, Chairman, Mr Gavin Hewitt, Chief Executive and Mr Campbell Evans, Director of Government and Consumer Affairs, The Scotch Whisky Association, examined.

Chairman: Good afternoon, gentlemen, can I welcome you to the Scottish Affairs Select Committee and our inquiry into the proposed strip stamps on spirits. Can I also declare that I am Chairman of the All-Party Group on Scotch Whisky in Parliament and some of the members of the Committee are members and others office bearers.

Mr Duncan: I am Peter Duncan, Vice-Chairman of the same All-Party Group.

Q1 Chairman: Can I thank you, first of all, for your attendance and your written submission. Before the Committee turns to specific questions do you have anything you wish to add in support of your submission?

Mr Good: Can I first of all thank you for giving us this opportunity today. The Scotch Whisky Association is the trade body which represents the industry at home and abroad. Its main objective is to promote and protect Scotch Whisky. There are 57 member companies of the Association and they account for more than 95% of the worldwide sales of Scotch Whisky. Representing the industry today we have Gavin Hewitt who is the Chief Executive of The Scotch Whisky Association, Campbell Evans who is Director of Government and Consumer Affairs at the Association and myself Ian Good, Chairman of the Association. I actually have a day job and that is Chairman of the Edrington Group which owns brands such as Famous Grouse, Macallan and Highland Park. Scotch Whisky is of crucial importance to the economy of both Scotland and the United Kingdom. It is crucial that we remain competitive in what is an increasingly competitive market place in alcoholic beverages. Making certain that that competitiveness is maintained is crucial because it has a direct impact on jobs, particularly in rural areas. There are 10,000 direct jobs attributable to the Scotch Whisky industry but within the United Kingdom there are 65,000 jobs which rely on the industry. While it might seem that there are a number of areas where there is pretty low unemployment there are some areas where the Scotch Whisky industry is the important employer. My own company is based in Drumchapel which is an area of high deprivation, we are by far the largest employer in that area and if anything should happen in terms of bottling jobs as a result of strip stamps it would have a catastrophic effect not only on the company but in the area. Let me say at the outset that we are totally committed to tackling spirits duty evasion. Fraud of any description is not in the interests of the Scotch Whisky industry, it is not in the interests of people who are trying to promote brands. Again, if I talk of my own company, we spend a tremendous sum of money promoting Famous Grouse as a prestigious product. If we lose control of the distribution of that brand, we lose control over how we promote that product, so therefore we do not want anything to do with anything that is remotely connected with fraud. We do not believe that tax stamps are the appropriate or proportionate solution. The introduction of tax stamps on bottles would add considerable cost

across the supply chain, it would reduce competitiveness and productivity while in our opinion doing little to tackle spirits fraud. The cost would be significant, it is not just a question of the labour costs, the material costs but there is a significant capital cost, capital in terms of new equipment that is required but probably most importantly, and things that people tend to forget, there would be a significant working capital outlay. That working capital would be a lost opportunity for the industry because if we had the capital that was being used to finance this scheme we would be able to use that capital in things which would be more productive for our industry and more productive in promoting Scotch Whisky overseas. We welcome this opportunity and particular inquiry because we believe it gives us an opportunity to explain where we have got to so far, and what steps we plan to take. What we feel is that we were set an exam question by the Chancellor in the Pre Budget Report. We believe we have answered that. We have not only answered it in terms of reducing spirits fraud but we are going to do it quicker, we are going to give him more revenue than he talked about and I think that is a win, win for the Chancellor and for the industry. We believe the revenue gain that the Treasury would have could remove at least 50% of spirits fraud. The industry's proposals offer faster implementation of anti-fraud measures, our alternatives offer a more enduring effectiveness due to the robustness of the way we are going about it and we believe the response is more proportionate in response to the level of fraud that is being talked about. In short we are offering the Chancellor twice the revenue he anticipates receiving from tax stamps, he is receiving it two years early and I would ask you what other government project offers such a return. We look forward to explaining to the Committee how we believe we have answered these questions. Thank you very much.

Q2 Chairman: Thank you very much. We understand that you met the Treasury Minister John Healey this morning and despite it being so close to the Budget was he able to give you any indication as to whether or not the Government had decided to go ahead with these proposals?

Mr Good: There was no indication at all. We explained the answers to the questions we were set in the Pre Budget Report. He listened to what we said. We particularly commented on what we thought was the win, win situation but there was no response. Did you read anything into it, gentlemen?

Mr Evans: Normal Pre Budget response.

Chairman: Can we now look at tackling fraud?

Q3 Mr Sarwar: Mr Good, from your opening remarks it is very clear there is no difference in principle between the Association and the Government over the need to tackle tax evasion, it is in nobody's interest. Both sides agree that we need to tackle the fraud but unfortunately there are some differences of opinion about how we can achieve this goal, could you summarise why you are not

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convinced by the Government's argument for the introduction of this tax stamp? You have given some reasons but we would like to hear more.

Mr Good: Let me just say there is significant evidence in other countries where tax stamps have been used or indeed where tax stamps used to be used, the United States being the best example. The US Treasury said when they decided to abandon tax stamps that it did nothing to increase the revenues and it did nothing to prevent any question of fraud.

Q4 Mr Sarwar: What reasons have ministers and officials given for them not being convinced by your suggestions as set out in section three of your memorandum?

Mr Good: One of the problems has been the question of quantum, just how big is this issue. There has been a great deal of to-ing and fro-ing between our industry and Customs as to what the amount of fraud is. We are significantly apart on that but rather than going into all of the arguments why we think we are right and we think they are wrong the National Audit Office are investigating it, so there will be what you might call a referee giving the result.

Mr Evans: In terms of the actual proposals we have put on the table it is not a case of them having rejected the proposals, it is more a case of them having to go through them. What we were doing this morning is explaining these are a package of measures that should be seen as a package to tackle fraud, both outward diversion and to some extent inward diversion. They have seen bits of it but what we have done now is bring them together and a formal submission will be going in in the next couple of days which will pull all these bits together. It is not a case of saying they have rejected it but they have analysed it bit by bit and now we have packaged it up and said that this is the way to tackle fraud.

Q5 Mr Sarwar: It is not easy to quantify how much tax evasion is because of this tax fraud, do you believe that over the last few years because of Government measures and whatever the industry is doing it has helped tremendously to minimise the loss, to help reduce the loss?

Mr Good: Yes.

Mr Hewitt: The proposals which the Chancellor and Customs & Excise were proposing to us two years ago in a consultation exercise were a result of very high levels of fraud in the period between '95 and '98. There was a particular fraud case, the London Bond, and everyone recognised at that particular time that things were going wrong. It was a direct result of the rules which were introduced as a result of the single market and the controls which changed. That then led to the consultation, which went on to the whole process of the seven proposals which were put to the industry and trade and open to formal consultation. We replied to them and they came back to us. Right up until last October we were negotiating on a process to not go down some of the conclusions which Customs & Excise and the Government and Treasury offered us but to offer alternatives. We finished up negotiating but not signing or implementing, yet, a memorandum of

understanding between the producers and Customs & Excise which was to tackle the whole question of the areas where the risk was most and where that risk was the highest. That was the basis on which we were negotiating with the authorities to find out how we could tackle fraud in the wake of the 1998 troubles. Suddenly out of the blue we come back to the proposal for tax stamps which, of course, the Chancellor in his 2002 Budget Statement had said was not the answer because the compliance costs for industry were too high. I think it is significant, without going into the level of fraud, that the fraud figures which have been used by Customs & Excise over the last few years have indeed been changed and are changing. We have an example where one year it is £450 million for the year 1999–2000, the next year on the next statistics they are 350 million and suddenly we have a £600 million figure for 2001–02. There is a moving target, if I may say so, and it is extremely difficult to work out, that is why we were worried about the fraud estimates. We have no strong evidence that fraud is at anything like the £600 million level. Intuitively, why? In 1998 there were a very large number of complaints from the industry about market disruption, people were not able to sell to the retailer on the corner. There are no complaints whatsoever from the industry about market disruption, suggesting there is no serious problem in selling legitimately into the trade. Secondly, if we were to take the figure of £600 million and look at what is happening then we would be talking about a 50% growth in spirits consumption between 1992 and 2002. It is not intuitive it is fact, we have no evidence there are seriously more spirits being consumed in the United Kingdom than in 1992. There are two very strong indications there is something which is difficult. Can I make one other point, which is the methodology which is being used by Customs & Excise in calculating the £600 million figure. It is what is called a gap analysis. Gap analysis in their terms and their methodology produces a £600 million figure. It is interesting when they apply that same gap analysis methodology to wine and beer it came up they were getting more revenue than they should, the figures were showing for beer and wine that they should not be getting that amount of revenue. I think if I was a punter I would think there was something wrong with my methodology.

Q6 Mr Weir: Just following up on that, you say in your submission to the committee that if you accept Customs & Excise estimates then every bottle of spirits in every independent shop must be fraudulent, which is somewhat startling. Talking about methodology, you said that the National Audit Office was looking into the difference between yourself and Customs, have you agreed the methodology that is going to be used for that? If you do not it does not seem to me it is going to take you very far?

Mr Hewitt: We had a lot of discussions about methodology with Customs, we were not making a great deal of progress, they stuck to their methodology and we said intuitively we thought that

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methodology was not indicating what it was that we were feeling in the market. If you remember the National Audit Office produced a report on alcohol fraud just before the turn of the year and that is being reviewed by the Public Accounts Committee. We encouraged the fact that since we were so far apart on methodology, and we were not going to agree the basis, it is sensible to have some sort of independent arbiter to look at what our methodology was and what their methodology was and to see if we could agree a base against which we were going to create a policy.

Q7 Mr Weir: How long was it going to take to do that, do you know?

Mr Hewitt: We believe they will report to the Public Accounts Committee before the Budget.

Q8 Mr Carmichael: Following up on the point about the involvement of the National Audit Office we are two weeks now from the Budget what prospect is there, do you think, that the input from the industry is going to be given its proper consideration in Treasury decision-making or are we just dealing with a done deal here? Are you guys just being sold a pup?

Mr Good: The important thing is there has been a lot of debate about the quantum of the fraud. The question that the Chancellor asked us was, "come up with a better method than tax stamps". We believe we have conclusively done that. We have come up with a better method that produces more revenue and quicker. To my mind that is game, set and match in relation to the question we were asked. The whole aspect of how much it is and all of the rest of it. If the figure was £600 million, and outward diversion fraud accounts for roughly 50% of all fraud, and if the suggestions that we are making are implemented £300 million will be recovered. The Chancellor asked for £160 million.

Q9 Mr Duncan: Alistair referred to a done deal, given there is this perception we are going to have to undertake another government U-turn to get them out of this, you have produced a system that is going to give them twice the revenue and they are going to get it two years earlier according to your initial comment, given they have already U-turned what confidence can you have that you are going to be able to convince them of the case?

Mr Good: The one thing about The Scotch Whisky Association is we are non-political, it is not a question of U-turns or anything like that. The Chancellor said, "I believe I am losing money through fraud, can you come up with a better idea? If you cannot I will put tax stamps on". We believe we have come up with a much better answer which produces more revenue, it is not about U-turns or political shenanigans, it is a straightforward commercial question and we have answered it.

Q10 Mr Duncan: I meant that given the Chancellor has had to go back on his comments on the 2002 statement there was a degree of embarrassment there, I just meant there is obviously a political

difficulty enforcing another U-turn when he has already turned round once. I accept with confidence that you think you have a case to make. The Scotch Whisky Association have very clearly made their case here, what is the level of co-operation with the Gin and Vodka Association, do they have distinct interests here and distinct proposals here? Is your proposal a similar proposal to theirs or are there different emphases?

Mr Hewitt: The proposals which are being offered and will be offered in the final form to the Treasury are proposals which come from the whole of the trade, not just the producers but the whole of the supply chain too. The Gin and Vodka Association Director General has been chairing the trade side of the Joint Alcohol and Tobacco Consultation Group so we have exactly the same interests in all of this. There are no serious differences. There are differences about what you can do because gin and vodka can be produced anywhere in the world, Scotch Whisky cannot. The real significance at this time in terms of the alternative package which we have offered, is it brings in every bit from production right through to the bottle appearing on the shelf or behind the bar. Significantly the warehouse side has come up with proposals which have not been offered before, never been looked at before, which is to do the same amount and to offer the same sort of level of co-operation that we as the Scotch Whisky industry producers were offering two years ago, which are enshrined in the Memorandum of Understanding. The significant ones are the warehouse controls and the revision of what is called the guarantee system and that affects everyone in the system, particularly the warehouse. It is therefore a unanimous offer from the whole of the trade and industry, from production to supply, and I think that is the significance of what it is that we have now put on the table.

Q11 Ann McKechnin: I take it from that you are working in alliance with the Gin and Vodka Association in connection with your work with the Government, I just wondered whether or not you can comment whether you have made any suggestions about inward diversion? You talked about your proposals for outward diversion, have there been there any proposals by the industry in connection with inward diversion?

Mr Hewitt: Indeed we have. Since 55%–60% of current fraud is outward diversion a lot of our proposals address that but a lot of proposals relating to warehouses also affect inward diversion. Let me take an example, a whole lorry of whisky, gin or vodka comes in at Dover, it is stopped by Customs at Dover, it has all of the paperwork and it is going to warehouse X in the Midlands. At the moment if that bit of paper given to Customs at Dover looks okay the lorry will proceed, there are no checks whatsoever that that lorry ever goes to warehouse X in the Midlands. What we are saying is that effectively that person who stops the lorry at Dover should phone warehouse X, if warehouse X says, "sorry, I am not expecting a load" that is the first indication to Customs at Dover you should stop that

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lorry, hold it back until you are sure that it is going to deliver to warehouse X. Equally the warehouse man would have the responsibility of notifying the arrival of that load. This is giving material information to Customs & Excise to put their assurance, their enforcement resources into the areas which are most at risk. If Edrington, Diageo or Allied is delivering those are very tightly controlled.

Q12 Ann McKechin: Are you saying at the moment that if a trailer arrives at Dover that Customs & Excise never take the opportunity of phoning up any warehouse to check whether the load is coming into them?

Mr Hewitt: Occasionally they do, but it is a rarity. They never check that it actually arrives there and so effectively if a lorry is stopped at Dover and that lorry has a bit of paper they will usually let it go on its way. Where it is stopped and checked then that lorry will go to their warehouse even if it is not expected but their warehouse man never comes back and says to Customs and Excise, "I am puzzled, where did this load come from, why did it come here?" There are no checks and balances, there is no control over those processes. Meanwhile there are another nine lorries which are not checked which disappear.

Q13 Ann McKechin: You propose warehouses inform Customs & Excise of every load they are anticipating and when they arrive?

Mr Hewitt: Not every load, there are high risk loads and categories of movement which would cause concern where there is cash rather than credit lines. There are risk elements and where those risk elements are involved then you report.

Ann McKechin: Thank you.

Q14 Mr MacDougall: Can I say first of all your opening remarks regarding employment and the importance to the economy of the whisky industry I take on board very seriously. In my constituency I have the distillers Diageo, and in a former coal-mining community I can tell you that unemployment levels are quite high and therefore the industry is very important. I would be very keen to see a sensible solution to the problem. Can I say to you I come from Fife and so does the Chancellor, I am not sure that will influence him at all, I hope he makes the right decision at the end of the day. You quote instances of unscrupulous traders using genuine tax stamps to disguise fake spirits, do you consider the introduction of the tax stamps in the United Kingdom could exacerbate the problem of fraud?

Mr Good: If you are trying to develop a brand of Scotch Whisky clearly people who see a brand being successful will try and copy it. There are a number of security aspects that we already have but if you are walking into a store and you see they all have tax stamps on them then I think that would perhaps convince the consumer that that is genuine. I think it could work against the interests of the industry in terms of making sure that it is *bona fide* Famous Grouse or Johnnie Walker, or whatever.

Q15 Mr MacDougall: Are there any other examples that you can use?

Mr Evans: We have given you a number of examples of countries where it does not work, in Hungary 15% to 20% of the market is fraudulently traded despite the fact there are tax stamps already in there. The most recent example is the one in Ukraine. Ukrainians were having a lot of problems with forged stamps so they brought in on 1 January this year a new, state of the art hologram seal, the type of thing Treasury and Customs & Excise are talking about here, hologrammed strip stamps. Within three weeks the police in Kiev had found 60,000 bottles of vodka with the new supposedly fool-proof tax stamps. I read in the papers last weekend there are a series of forgeries going on surrounding passports, if they can forge passports they can forge tax stamps. Each one of these on a standard bottle of Scotch Whisky is going to be worth £5.50 or about £7.50 for a litre bottle. These are valuable commodities and therefore there is plenty of incentives for people to produce forgeries, they do not have to do it here they can be doing it overseas but there will be a market for forgeries.

Mr Good: On that point, that represents £50,000. Those are strip stamps that if we were bottling 1.5 litres, which is the bottle you see in the pub on the gantry, if we put strip stamps on those that would represent £50,000.¹ If we were bottling the 70 cls—which are the bottles you would buy in the supermarket that would represent £50,000. There is enormous scope and very lucrative takings for those unscrupulous people who want to try and copy.

Q16 Mr MacDougall: Can I ask one more question, on the basis of the very powerful argument that you presented to the Chancellor, he believes and we all accept there is fraud and there is loss to the Treasury, your figures you quoted here in terms of the potential for fraud regarding a stamp has hardly taken into account these figures because they are plus?

Mr Good: I do not think we have taken it into account.

Mr Evans: The Customs & Excise in their assessment of the benefits of tax cuts have not taken account of the fraudulent activity that will arise, nor have they taken account of the likely drop in revenue as sales fall because of the increased cost of the bottle up by 30 or 40 pence, which is what the impact of tax stamps would probably be.

Q17 Mr Weir: I notice that, in your presentation to the Committee at paragraph 6.12, you mention that tax stamp regimes, currently found in only four EU Member States, might themselves be unlawful according to European Commission officials. Have you investigated that further?

Mr Evans: Let us just clarify it. As you rightly point out, this was a comment made by an official that we approached previously to discuss tax stamps. One of

¹ Witness presented packages of strip stamps as a visual example.

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the reasons why we did so was that we were concerned about the barriers to trade that tax stamps create in other markets and indeed we were in the midst of launching an action in Portugal against the changes in tax stamps there which we believe were detrimental to the industry. So, we wanted to know on what grounds the Commission felt that tax stamps would be viable. They just expressed the view that it perhaps had not been challenged; they did not say whether they were or were not part of the legal process within the EU that they could possibly come under some challenge. Interestingly, if we look ahead as to what the impact of UK stamps could be, we know that countries look to see how Scotch Whisky is taxed in this country as an example of how to tax it overseas. If they see tax stamps coming in on spirits here, they may well feel that this is something they can get away with overseas and, in the case of Portugal itself, we have already been alerted that the British Embassy, which was previously supportive of our challenge to the Portuguese system, believes that it would no longer be in a position to help us because they are compromised if the British Government go down this route.

Mr Hewitt: The debate centres really on the duty point and the tax stamp. If you pay the duty at that point, that is actually contrary to the regulation. Duty is only paid at the point of release to the consumer. So, this is the issue which has never been tested but is certainly a legal point. We had a good example when the Belgian Government was challenged by the Commission because they were charging and putting duty on at the point of production on tobacco rather than the point of release through the retail trade. That was queried by the Commission and I think it is had been resolved because the Belgians have pulled back from that. So, it is a very specific legal issue.

Chairman: Can we now move to the effect on employment.

Q18 Mr Weir: In your submission, you mention that some 41,000 jobs in Scotland and 65,000 across the UK depend upon the industry. Do you have any indication of how many of these jobs might be lost should another tax be imposed on the industry? Will it be concentrated on the distilling sector or how will it be spread across the sectors of the industry?

Mr Good: I think I said in the opening remarks that the Scotch Whisky industry is in a very competitive environment in terms of the alcoholic beverage market. Anything that increases the costs of the industry will be detrimental to the well-being of the industry. If I use the United Kingdom as an example, we have not had a price increase in the United Kingdom for five years. Therefore, we have to look at our costs and we have reduced costs, but you do reach a point where you cannot take any more cost out of the business. There are very real dangers this year that there are going to be increases in costs of glass and of cardboard, and these are things which, frankly, the industry will not be able to swallow. If we add the tax stamp cost on top of that,

then that might just be the straw that will break the camel's back for some companies and that will clearly have a detrimental effect on employment.

Mr Evans: I do not think anybody will say that this is the number but what we have heard from some of our members is that they have been looking to take the costs out of their business. Indeed, they have been making redundancies in order to cut costs so that they can keep going in the current climate. One of them has told us that, if tax stamps came in, more costs would be added to the business than what they have managed to save by these redundancies, which puts them back in a worse position than they were before and they are therefore very concerned about whether it makes any sense to continue in the UK market or which parts of their operation they can continue to run. We know that other companies, which are perhaps large companies and therefore might at first sight be more able to deal with the costs, operate quite often on an intra-company basis in terms of keeping the cost of production as low as possible and therefore some of the production, particularly of other spirits that have come to Scotland because of the business cluster here, might then go to lower-cost countries where the price of glass, for example, labour costs or whatever are cheaper. We are certainly getting that sense from our members, albeit that nobody is able to put a finger on it. It is not a case of saying that this is definitely going to happen, but people will certainly be looking at the cost base and looking at the jobs aspect.

Q19 Mr Weir: Are you seriously suggesting that a Scotch Whisky company could export whisky to somewhere else to be bottled and re-imported into Scotland?

Mr Good: No. Where we have members who have a range of non-whisky products that are currently bottled in Scotland, if they get to a situation where the additional costs which are put on to spirits and if whisky is a major part of that equation, then one route they have is that they would bottle their other spirits elsewhere in a lower labour-cost country or a lower material-cost country. It would not be specifically Scotch Whisky.

Mr Hewitt: There is a specific case of that which has just happened.

Q20 Mr Lyons: Just on the question of the tax stamp itself, putting aside the argument with glass, bottling and so on, how much would producers need to put on a bottle of whisky to deal with the tax stamp if it were implemented?

Mr Good: I will give you an example of our company. If tax stamps were introduced, it would increase the cost of a case of 12 bottles by more than £1. That is the additional cost; we would actually do it through machinery, so it would be capital cost of that. There is the increased cost of security. These strip stamps will need to be kept in extremely secure conditions and some people will not be able to insure these. You think, this packet here is £50,000. I will give you one example. Our company's normal size of order to our distributor would mean that we would be buying £1.8 million worth of strip stamps which

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would be lying in our premises and having to be controlled in our premises. In addition, I mentioned the cost of capital. There is a specific cost of having that capital tied up and then, in addition to that, there is the opportunity cost missed. So, all these added together would mean an increase, in our case, by over £1 a case. For other people it is higher because they are not so mechanised as we are.

Q21 Chairman: Does that include the added insurance costs?

Mr Good: If people obtained insurance, that would be an additional cost.

Mr Hewitt: That passes across and through, that is the cost to the producer. If you put it all the way down the supply chain and remember that you are adding VAT on top of the higher cost price, eventually the cost to the producer gets translated into a cost on the shelf of, we calculate, a 30 to 40 pence per bottle increase.

Q22 Mr Lyons: May we just clarify that point. In your memo, you spoke about compliance costs. Would the security costs be additional to the compliance costs or are they included in that?

Mr Good: They are included in that total cost because, for example, we would have to have a secure unit and there would be the capital cost of building that and there would then be depreciation on that cost and that would be a real cost to the business.

Q23 Mr Lyons: Just to come back to the other question, what difference would I see on a bottle of whisky on the shelf if you were to implement all of these costs?

Mr Good: If you take it at over £1 a case and add on duty, VAT and retailers' margin, it could be as high as 40 pence per bottle.

Mr Evans: You have to bear in mind that some businesses will change the way in which they operate. For example, supermarkets which buy their product duty free at the moment may switch to duty paid business and therefore will go straight to the supplier and will want much more just-in-time business which will add costs to the supply of those products to supermarkets. The nature of the business may well change which will also add costs on to the supermarkets and that is certainly the part where they would see a big hit on their costs.

Q24 Mr Lyons: So, it could go beyond the 40 pence?

Mr Evans: One supermarket suggested beyond that but, across the trade, that is what we believe is a reasonable estimate.

Mr Hewitt: It is not an exact calculation; we have tried to make sure that they are average costs. Other people would have higher costs but, in average, that is what we think we would finish up with.

Q25 Mr Sarwar: It is not easy for any industry to absorb extra costs but, with the larger industries, it is relatively easy. What about the small industry? There are going to be setting-up costs and then there are going to be the added costs of insurance. The

figure of £50,000 has been mentioned and we can imagine the sort of premiums that the insurance people will be looking for. We are living in a competitive world. Do you think that adding these costs will affect our competitiveness abroad?

Mr Good: Taking that point first of all, in terms of developing Scotch Whisky worldwide, only 10% of Scotch Whisky sales are in the UK. However, it is crucial that brands which are trying to develop have a strong home market. If there is 40 pence extra on a bottle, I think it would be reasonable to assume that sales would fall and the UK market would decline and that will hit the Exchequer. I do not think that the Chancellor has thought of the impact this will have.

Mr Hewitt: May I add a little about the competitiveness and the competition inside the industry. Let us take this bottle, Ballentine's from Allied.² This was a bottle with a Spanish strip stamp produced on a bottling line which is equipped for that purpose. You can see what happens—it is not even attached because, on the bottling line, the glue did not work. That is the sort of bottle which has to then be taken off the bottling line by hand. That stamp has to be recovered and glued back on again by hand and, if it is destroyed, then they have to recover all the stamps by hand and put them on the receipts because, the only way in which they can get a refund from the tax authorities is to show that there are broken or damaged stamps. What a palaver! That is a mechanised bottling plant. There are smaller ones and it simply would not be in their economic interest to actually install a mechanised tax stamper on the bottling line. So, the bottles would simply come down the line and then they would hand label all of these. You can imagine the costs of hand labelling in comparison with the mechanised process. Then, there are all the other sorts of problems that are associated as well. At the end of this table, Campbell has a very special bottle. I have no idea how you would attach a tax stamp to a wax seal which is further down than a tax stamp. Even on a bottle like this, there are serious problems with doing that. Then you get to another one, the Scotch Malt Whisky Society, and here there is a fascinating issue. The Malt Whisky Society does not know what the alcohol by volume is until they have bottled it and, since the tax is related to the alcohol by volume, they are going to have to bottle and then say, "Ah, it is 58.7 abv", so they will then have to apply to Customs & Excise and say, "We need a stamp for 58.7 abv", which probably does not exist. So, they will have to then store it, wait for that tax stamp to arrive, let us say three weeks down the line, and then put them back again and put them all through the handling. Can you imagine the distortion of competition? Someone who has a mechanised line thrashes them through because they are doing 70 centilitres or litre bottles, and it is the small ones who really have huge manual costs because they simply do not have the economic justification.

² Witnesses produced various brands of Scotch Whisky to demonstrate to the Committee differences in shape and size of bottles.

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Mr Evans: May I just add one important point to that which is that people might say, “Well, if it can be done for Spain for these bottles, why can it not be done for the UK?” The important point is that, apart from Spain, no other market around the world is of the scale of the UK market but, even in Spain, the market is pretty much litre bottles and 70 centilitre bottles. Here we are looking at a much more complex system, a much broader range of spirits and a much broader range of alcoholic strengths and bottle sizes. So, this would be the most complex system of tax stamps that we have anywhere in the world.

Q26 Mr Duncan: We have talked about the compliance costs in terms of the cost on a case and the cost potentially on the retail price of a bottle. However, there is obviously substantial disagreement between the industry, SWA, and Custom & Excise in terms of the overall cost of compliance. They have suggested that, in year one, it would be £45 million and thereafter a recurring cost of £15 million per year. In its submission, the Association is suggesting that it would be £23 million of capital and then £60 million thereafter. What analysis have you done in terms of that difference? That is a radically different sum of money. These decisions are not taken lightly. How do you think that discrepancy has arisen?

Mr Hewitt: When the tax stamp issue was being looked at before the 2002 budget, there was a consultation process when we were trying again to calculate the compliance costs of tax stamps. That £45 million and the £15 million were figures which were extrapolated by Customs & Excise from our figures; they were not our figures. Secondly, the study which we did then was not complete; it did not cover the whole of the production to the bottle appearing on the shelf because in fact the tax stamp debate was aborted and we never finished our work; we never did the complete study of what the costs were. So, the £45 million and the £15 million are not our figures, they are Customs’ figures, but on the basis of an incomplete study and incomplete compliance costs. What we have done this time is to go right from production right to Tesco, if I may use them, looking at what the compliance costs are across the whole of the production to delivery.

Q27 Mr Carmichael: You are quite rightly focusing on the extra costs, but I think Ian said that you would never countenance bottling Scotch Whisky outwith—

Mr Good: No, I think the point was whether Scotch Whisky be bottled overseas and shipped back into Scotland and I said that was not the issue. The issue was that in fact it would be other products which are currently being bottled in Scotland which could be bottled overseas. I was not referring to Scotch Whisky.

Q28 Mr Carmichael: Surely, if it is economic for gin and vodka, you are putting yourselves at a disadvantage if you say, “No, we will not do that.”

Mr Good: Some people already do bottle Scotch overseas. By definition, it needs to be distilled, blended and aged in Scotland. After that, it can be shipped in bulk and bottled overseas.

Q29 Mr Carmichael: And bottling is the one aspect of the process which probably adds least value to it. Your own company produces Highland Park and Highland Park is special because it is distilled in Orkney and it has the whole issue of Orkney having a reputation for food and drink and the reputation for a clean environment and all the rest of it. I do not know that bottling it in Drumchapel necessarily adds any extra to that reputation.

Mr Good: No, but bottling in Scotland does. The point I was making is about where the bottling plants are located. If you look at Kilmalid, Dumbarton—high unemployment. Our group, Drumchapel—high unemployment. Kilmarnock, Shieldhall and Leven. These are big bottling plants where a significant number of people are employed. If you look at the 10,000 people who are employed in the industry, a significant number are employed at these bottling plants and a number of them are in areas of high unemployment.

Q30 Mr Carmichael: Exactly, so is it fair comment to say that these proposals could have a disproportionate effect on those communities who are already most fragile and most vulnerable and least able to meet the challenge?

Mr Good: Scotch Whisky needs to be competitive. This is another burden on Scotch Whisky. If we are not competitive, we will not compete in a very competitive market place and that will affect the overall sales of Scotch Whisky. That will have a detrimental effect on employment and the people who will feel it most will be in the areas of high unemployment because that is where the largest numbers are employed.

Mr Hewitt: On these bottling lines, it is not just whisky: it is gin, vodka, Malibu, you name it. If the companies decide to manufacture those products—gin and vodka can be done anywhere you like—outside the UK and bottle them outside the UK, the production costs of bottling whisky in Scotland on those bottling lines obviously goes up.

Mr MacDougall: The concern that is coming across to me is that whilst you might not have a distillery aspect of the business, you have a bottling plant, and, if you lose the vodka and the gin through being able to produce that anywhere at all that is more competitive, then the overheads for the plant that exists are still the same. Therefore, the temptation would be to concentrate on plants in maybe one or two areas and shut the others down and of course that would be a loss to the Treasury as well. I see the point you are making and I hope that these points will be taken on board.

Chairman: Can we move to the implications for exports and imports.

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Q31 Mr Weir: Have you any indication of whether the imposition of the stamp, leading presumably to an increase in the cost of a bottle of Scotch, will affect overseas exports, for example to the United States or to Japan?

Mr Evans: I want to go back to the barriers to trade issue which we touched on before and the ability of the UK to stand up for Scotch Whisky around the world. We have had a lot of good support from the DTI over the years in terms of breaking down trade barriers. Japan, Korea and Chile are three areas where we have had great success on the tax front. We clearly require that support from the UK has credibility behind it and that becomes more difficult if there is a tax stamp regime which we are trying to fight against when the UK has just set one up. So, our ability to get support would be a concern to us and of course, if the cost of the business goes up across the board, that cost of business is reflected in sales around the world, not just sales in the UK where the tax stamp happens to apply.

Q32 Mr Weir: Specially, the increase in common is the cost of a bottle of whisky going up by 40 or 50 pence and I appreciate that, with currency fluctuations, it may go up even more.

Mr Good: That was the UK figure.

Q33 Mr Weir: What would be the effect on an export bottle? How important is a cost movement in the number of bottles sold in, say, the United States or Japan?

Mr Good: I think you would need to come back to the point that is being made about the bottling plant. Bottling plants have what is known as a very high breakeven point. In other words, throughput is crucial. I will use Kilmalid at Dumbarton as an example, which is where they bottle Malibu, gin, vodka and a number of other products. They have the critical mass for that total plant through Scotch Whisky and other things. If the price of Scotch Whisky is going up because of the strip stamp situation and it is then compounded because of other cost pressures and they, let us say, move the bottling of gin to Spain or whatever, then that clearly increases the cost of what is remaining in that plant in terms of Scotch Whisky and that would make the Ballentine's that they sold to the United States more expensive.

Q34 Mr Weir: I understand that and I am sorry to be pedantic about this but I am just trying to understand. You quoted a cost price increase within the UK of around about 40 pence and I am just trying to understand what the cost increase is likely to be on an export bottle and what the impact is likely to be on the export markets. I understand what you say about the plant and how the cost will increase, but I am just trying to get an idea of the amount of the increase and the impact on the export market.

Mr Good: I could not give you a figure for output because it is about throughput. I do not believe that you could estimate what effect a 40 pence per bottle increase in the retail price would have on the volume

of sales in the UK. If the volume of sales in the UK fell and that increased your overall cost because your throughput is less, I think that the impact that would have on the cost of a case to the United States or to Japan would be impossible to estimate at this stage.

Mr Hewitt: There is the question of international trade. Strip stamps have been successfully seen off in many areas or people have been persuaded to back off from strip stamps which I do think have a cost in that, every time you apply them, there is a cost. The United States and Germany got rid of them, Belgium has not gone ahead with them and Greece has abolished them and they have actually reduced the cost of getting that bottle to that market. To the degree that we in the UK were to impose a tax stamp, we are giving another argument to a number of people out there to actually introduce forms of discrimination because you are actually adding a cost to the delivery of the bottle which therefore makes it less competitive in that particular market, let us say against an overseas producer or whatever it might be. It is very difficult to calculate.

Q35 David Hamilton: I am still trying to get over the fact that Malibu is not produced in the Caribbean! For the last 45 minutes, we have been discussing the prices and the price differentials that will come. I am old enough to remember imitation whisky coming into the country and that type of thing. If the price of Scotch Whisky increases in the UK, will it become a more tempting target for overseas producers to bring cheap imitation whisky through?

Mr Good: Yes and I think that is the point I was making earlier about brands. The future of the Scotch Whisky industry is about selling a unique premium product all over the world and we are very fortunate that over 200 countries buy Scotch Whisky, so it is a very successful export product. If the UK market is being priced effectively out of the consumers' reach, then people will try to come in and fill that hole. We had an example in the late eighties when Canadian Whisky came in and in fact you can still see Canadian Whisky being sold in the supermarkets at a very low price. People will come in and try and take some of that market that is whisky.

Q36 David Hamilton: Talking about imitation whisky, presumably the UK's Irish Whiskey industry would also be affected by the stamp duty.

Mr Evans: It certainly would and the Budget is on St Patrick's Day!

Q37 Mr Weir: Just taking up where David left off there, what would be the effect in respect of the Irish Whiskey industry in the Republic of Ireland? Is it likely to be a beneficiary of this if it does not have the same stamp regime?

Mr Evans: I think obviously what they are selling in the UK will have to have stamps, but there may of course be a move to cross-border shopping in the opposite direction to the one we see at the moment in Ireland. It is quite a complex market over there.

Chairman: Can we look now at new technology.

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Q38 Mr Carmichael: One of the recent pieces of correspondence that I received came from the company Spectroscopic and Analytical Developments Limited that have produced what they are calling a new whisky authenticator in association with Diageo.³ I am glad to see nods coming to this! They say, “A technically advanced, inexpensive solution to the detection of counterfeit product which could avoid the use of stamps.” You are obviously familiar with this. Have you had the opportunity of seeing this particular piece of kit in action and do you think that it may have some sort of contribution to make to the war against fraud about which we are all concerned?

Mr Hewitt: I helped Diageo launch it, so I have actually seen it in action at least in the Diageo headquarters, not actually in the bar where it is going to be used. It is a fascinating piece of kit. At the moment, a trading standards officer can go into a bar and take, let us say, 20 samples of whisky with no means of analysing them. He will take all those examples back to the lab. It would take two weeks to analyse them and they would all have to be analysed. What is planned with the authenticator is that someone can go into the bar, can take again 20 samples, five of which let us say might fail and 15 pass. In other words, it is a very quick way and you only have to take the five failed back and then, if they actually were shown through further lab analysis to be counterfeit whisky, not Famous Grouse but someone who had filled the bottle with some other cheap version, then indeed there is an opportunity for prosecution under the trading standards. It is geared at the moment to Diageo’s whiskies. You will notice occasionally in some Diageo whiskies that there is a quality stamp over the top. They are not talking about tax stamps, they are talking about quality control stamps. The importance of that authenticator is to allow someone, whether it is in a foreign market or in a home market, to quickly analyse his samples and to know what he has to concentrate on. Can I also make a secondary point picking up Mr Hamilton’s point. The danger of a strip stamp over a bottle is to suggest to the person who is buying it that that is an authentic product. You have actually legitimised the product. The fact that it is a Famous Grouse bottle, whether it is counterfeit whisky inside that Famous Grouse bottle, but with a UK Government tax stamp, how on earth is the consumer going to know and in fact he will assume that it is a very legitimate bottle of Famous Grouse, so he is not protected one iota from counterfeit whisky which is masquerading as something else.

Q39 Mr Lyons: If it has been stamped in your bottling plant, how can it not be authentic?

Mr Hewitt: If it is in a bottling plant and going all the way through, of course it is authentic, but a lot are taken in behind the bar. There is a practice where people will fill up behind a bar—you have a Famous Grouse or Bell’s or whatever it might be—

Q40 Mr Lyons: Leaving that aside, you make the point that, if it has a stamp, people will feel it is authentic.

Mr Hewitt: Yes.

Q41 Mr Lyons: Surely, they will feel entitled to think it is authentic.

Mr Hewitt: They will feel entitled to think it is authentic even though it is not authentic and the reassurance that the tax stamp will give to say that it is authentic may be false because around 6% of whisky in the UK market is counterfeit.

Q42 Mr Carmichael: Presumably you mean that somebody who forges a Famous Grouse label, for example, will have little compunction about forging a stamp strip.

Mr Hewitt: Absolutely.

Q43 Mr Carmichael: I can see the obvious Trading Standards advantages from a device such as this. Is there an established link between people who are producing a counterfeit product and those who are avoiding duty?

Mr Hewitt: I am not saying that they are not the same people but they are not necessarily the same people. Someone will take advantage of the market in whatever way they can. The people who produce counterfeit stamps may be totally different from the people who want to fill bottles with a false product and masquerade as something else.

Q44 Mr Weir: It does seem to me that this may have an application in identifying counterfeit whisky, but I do not see where it fits in with the whisky stamp because presumably the top is off the bottle and it is up on the optic and you could not get—

Mr Hewitt: It is no connection really with the issue of stamps. It is a different issue which is counterfeit.

Q45 Chairman: Gentlemen, we have come to the conclusion of our questions but, before we finish the evidence session, is there anything you feel you wish to add to any area that perhaps we have not touched on?

Mr Good: I think it might be worth just talking very briefly on the specific measures that we are putting to the Chancellor in order that you are aware. On the one hand, we are saying that tax stamps are very costly and ineffective and I think we should give you comfort that what we are suggesting is sensible and commercial.

Mr Hewitt: At the back of our submission, there is a list of the various measures. I will not go through them all but I would like to draw two in particular to your attention which are ones that we put a lot of weight on and believe that they are ones which are new and novel. Everything in that list is additional to current practice. Every bit of that list would also work on the basis of cooperation and partnership working with the assurance officers and the enforcement officers. We believe that that is the only way in which you can actually tackle fraud effectively. If you impose something against people’s will, you lose cooperation, you lose the partnership

³ See Appendix 1.

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and you lose the flow of trade and intelligence information to actually beat the fraudster. The two things which I would like to highlight are first the revision of the guarantee system. Not a single movement of whisky, in our case, moves without a guarantee. At the moment, there are guarantees which are given by warehousemen where they have no knowledge of who own the goods and what is happening to it. So, the warehousemen's guarantee is being abused. What we are saying is that this should be totally revised, turned on its head, and that the person wanting to move the goods should prove that he has a guarantee or that he has actually persuaded someone else to give him that guarantee legitimately, so that the movement cannot happen if there is a doubt or a risk. The warehouseman himself will not give the guarantee for the movement of that product. The consequence of this means that the fraudster, the illegitimate trader, will actually have to go to the bank himself to get a guarantee and this is the very sort of person who will not get a guarantee from the bank because he is involved with money laundering and all the other bits and pieces. So, there will be controls. He will find it extremely hard to put up the capital and to convince the banks that he can get a guarantee. The second one is the nature of the offer from the warehouseman to actually match the production site, the distilleries, in terms of the memorandum of understanding, the exchange of information and having also a joint taskforce to tackle fraud. This was not available last time round because we could not get it agreed. This time round, we have come together as a whole body and offered something which is indeed looking at from production to delivery and we believe that is the strength of what it is that we are offering.

Q46 Mr Weir: In addition to the joint taskforce and warehousemen, there was something you said earlier about more communication between customs officers, distillers and warehousemen. Playing devil's advocate, the Treasury may look at some of these and ask, "What is the cost implications for Customs & Excise?" Have you worked these out? Have you discussed with the Treasury as to what the cost to them would be if you need more officers or whatever?

Mr Hewitt: We have indeed because what we do not want is to say that every single movement needs control. Remember that effectively if 80% of

movements are in a sense from Diageo through their supply line to Tesco or from Edrington through their supply lines to supermarkets, these are not lines which are at risk. What we want to do is to encourage Customs, with our help, to actually concentrate on where the risk lies. It is not blanket, it is a risk-based assessment. I think that is in the spirit of where the Government are going now. They want to use their resources profitably targeted for delivery of a particular issue.

Q47 Mr MacDougall: You have presented figures to the Treasury and to Government in terms of the income that you can help to generate to the Treasury as opposed to the impact of the stamp. How quickly, how real and how powerful is the argument as to the income to the Treasury? Would that be obvious income? Obviously, the stamp would produce the immediate effect that the Chancellor of the Exchequer wants it to have, but how real are your projections and how quickly will the Treasury receive income from that?

Mr Hewitt: The whole process of the change in the guarantee system, the change in the warehousemen control and the notification can be done in the coming financial year. So, let us say that, by March 2005, we believe that all the controls which we need to have in place and which we have offered can be in place. What we are saying is that if those controls are particularly concentrated in outward diversion, although they do have impact on inward diversion, we are tackling the vast majority of what is actually happening in the fraud market at the moment. Therefore, if we have actually tried to choke off that, we have actually delivered more into the process of delivering more bottles on which duty has been paid. I do not want to put a money figure on it because there is a great dispute as to what the level of fraud is. We are happy that we can say that we are about 50% plus on cutting fraud. Apply that to whatever the level of fraud is and I hope the National Audit Office will help us on that one. What we can say is that we will produce a return in a very short time because of the commitment of the trade and industry showing a return to Treasury of 50% of what they are currently losing.

Chairman: Gentlemen, can I thank you very much for your attendance today and can I assure you that your evidence will be of great help to us when we come to making our report.

Tuesday 9 March 2004

Members present:

Mrs Irene Adams, in the Chair

Mr Alastair Carmichael
Mr Peter Duncan

Mr Ian Liddell-Grainger
Mr Michael Weir

Memorandum submitted by HM Customs and Excise

SUMMARY

1. In the Pre-Budget Report of December 2003 (PBR03) the Chancellor announced that the Government had decided to “*make preparations for the implementation from early 2006 of the Roques recommendation to introduce tax stamps for spirits*”¹. PBR03 stated that the Government would “*also consider any new proposals the spirits industry wishes to put forward in the coming months for alternative measures that would be as effective in tackling spirits fraud as tax stamps*”.

2. This memorandum gives background on the nature and scale of spirits fraud, Customs’ operational response to the problem to date, the expected impact of tax stamps and possible alternatives.

3. The Economic Secretary to the Treasury, John Healey MP, and Customs and Treasury officials, have had extensive discussions with the industry since PBR03 on all aspects of tax stamps and possible alternatives. These discussions follow on from the previous formal consultation on tax stamps conducted in late 2001 and early 2002, and a second formal consultation on other regulatory measures for reducing alcohol fraud in summer 2003.

4. At the time of submitting this memorandum, the discussions with the industry have only just been completed and the industry has yet to make its final submission to Ministers. It is expected that a further announcement will be made on this issue in the Budget on 17 March 2004.

NATURE OF SPIRITS FRAUD

5. In order to appreciate the purpose and potential impact of tax stamps or any alternative measures, it is important to understand the nature of spirits fraud and to estimate its scale.

6. Most UK spirits fraud is perpetrated through the diversion of non-duty paid products into the retail market. This can happen on import or export. Consignments of spirits, on which no tax has been paid, are obtained and diverted by fraudsters who cover their tracks with forged paperwork. This illicit spirit is mainly then sold through licensed outlets at full (or close to) retail price, meaning high profits for the fraudsters. Importantly, neither the consumer nor the honest trader has any other means of distinguishing illicit products.

7. The following examples illustrate the ease with which fraudsters can circumvent the system to gain access to duty suspended goods and divert them onto the UK market.

EXAMPLE 1: OUTWARD DIVERSION

Outward diversion occurs when product leaving a UK location intended for either another UK destination or another EU country is diverted onto the UK market.

A registered owner purchased 10 consignments of spirits direct from a UK producer. These were despatched by the producer, using a foreign transporter, intended for a tax warehouse in Portugal. In fact, the vehicles left the UK empty, and the goods were driven to a location in the UK from where they were distributed into the retail market. The stamped paperwork was returned from Portugal ‘proving’ that the goods had reached their destination, but was subsequently shown to be false. The guiding minds behind this fraud were deliberately so far removed that it was difficult to demonstrate any involvement.

£1.3 million in excise duty and VAT was evaded.

¹ Pre-Budget Report 2003, Para. 5.104.

EXAMPLE 2: INWARD DIVERSION

Inward diversion occurs when goods legitimately leave a production or storage facility in another country, are imported into the UK, and then are diverted onto the retail market without payment of UK excise duty.

400 full loads of spirits were consigned from France and Spain under the instructions of a group of UK companies. It is alleged that all consignments were diverted in the UK in three different ways:

- (i) goods were consigned from a French tax warehouse to a UK tax warehouse under duty suspension. The goods never arrived at the UK tax warehouse but falsified paperwork was returned to the French warehousekeeper;
- (ii) consignments were despatched under duty suspension from a French tax warehouse and the destination declared as being a post at the Greek-Turkish border. Some of the consignments were intercepted within the UK and seized. The declared border post was found not to exist; and
- (iii) goods were consigned from a French tax warehouse under paperwork declaring the destination as a tax warehouse in another country. The recipient warehouse was recently registered and complicit in the fraud. The goods were diverted to the UK and falsified AADs were returned.

£70 million in excise duty and VAT was evaded.

SCALE OF SPIRITS FRAUD

8. There is an inherent difficulty in establishing the scale of illicit markets. Analysis of these “tax gaps” is nevertheless a fundamental part of a strategic approach to tackling tax fraud. Customs first published an estimate of the scale of spirits fraud and an explanation of our methodology in 2001². We have updated our estimates and explained developments in our methodology annually since then. Our latest estimates, covering the year 2001–02, suggest that £600 million in tax is lost annually to spirits fraud. This means that 16% of the market is illicit and on average almost one in six bottles of spirit consumed in the UK has not had UK duty paid on it. Importantly the latest estimates also show that the problem is growing from an illicit market share of 11% in 1999–2000 to 16% in 2001–02.

9. Customs’ paper “Measuring and Tackling Indirect Tax Losses” published at the time of PBR03 describes the gap analysis approach currently used to estimate levels of excise (including spirits) fraud. This involves comparing levels of total consumption with known legitimate purchases and taking the difference to represent fraudulent consumption. The gap is normally reported as a percentage of total consumption.

10. Spirits consumption is estimated by combining on-licence consumption from the Family Expenditure Survey (FES) with off-licence consumption from the National Food Survey (NFS)³. The raw data are smoothed in order to reveal the underlying trends.

11. Household surveys are typically characterised by under-reporting. In order to overcome this, Customs assume that in 1992 there was minimal smuggling and cross-border shopping and that overall consumption in that year was equal to UK duty paid consumption and legitimate duty free purchases⁴. This assumption was informed by the expert opinion of those involved with assuring the alcohol regime at the time. It is also consistent with the view that it was the formation of the single market at the end of 1992 which created many of the opportunities for alcohol fraud.

12. This methodology and the data sets used produce a trend and scale of fraud that are disputed by the industry. They have proposed an alternative methodology that results in a falling trend and lower levels of fraud. Extensive discussions have been held between the trade and Customs on this point and in February the National Audit Office offered to examine both methodologies and offer a view. This move has been welcomed by both the Economic Secretary to the Treasury and the Chairman of Customs.

13. Both the trade and Customs argue that the differing views on the scale and trend of fraud are supported by other evidence. The industry notes that for fraud to be perpetrated at the sort of level required to derive an annual loss of £600 million, around 200,000 bottles of spirit would have to be diverted onto the UK market daily. They do not believe that this figure is credible. Customs finds this figure unremarkable in terms of our experience of fraud in other sectors and seen in the context of the scale of the whole market. UK consumers buy about 1.25 million bottles of spirits every day. The Scotch Whisky industry alone exports close to a billion bottles a year.

² in *Measuring Indirect Tax Fraud*, Pre-Budget Report 2001.

³ Since 2001–02 FES and NFS have been combined into EFS (Expenditure and Food Survey) but ONS and DEFRA are still responsible for publishing the FES and NFS equivalent data respectively.

⁴ Intra-EU duty free purchases are included. Intra-EU duty-free was abolished in June 1999.

14. Our intelligence suggests that the majority of illicit product is sold through the independent retail sector and off licence trade. This has been borne out by work conducted by one Customs team in London. They made 143 seizures of spirits from 300 shops visited.

CUSTOMS' OPERATIONAL RESPONSE

15. The vulnerability of the alcohol movements system to fraud results from two principal factors:

- first, the fact that under EU rules large consignments of high-value, low-volume product can be moved under duty suspension and sold repeatedly and across national borders without any tax being paid. A container-load of spirits can be worth over £100,000 in evaded duty alone; and
- second, the lack of any practical means for consumers, retailers or Customs to identify illicit product. Duty paid and illicit product can sit side-by-side on the shelves.

16. In recent years Customs have taken a number of steps to improve our capacity to identify and prevent alcohol fraud, including the implementation of recommendations made by the Roques report into excise diversion fraud⁵. However, faced with a problem that appears to be increasing, the Government believes that more needs to be done. In tackling spirits diversion fraud, Customs has not realised the significant progress we have made in other areas such as cross-Channel passenger smuggling and tobacco fraud. This is despite good co-operation from the spirits industry, with whom we have worked hard, both to explore measures which would reduce fraud and to improve both sides' assessment of and response to risk.

17. In 2001–02 there were seven successful prosecutions for evading duty on spirits and 91 successful prosecutions for cases involving the evasion of duty on mixed excise goods (“mixed” cases include mixed alcohol or alcohol with other excise goods such as cigarettes).

18. In 2002–03 Customs brought 21 successful prosecutions for duty evasion on spirits in the UK. In addition there were 34 successful prosecutions concerning duty evasion on mixed excise goods.

19. From April to December 2003 there were 11 successful prosecutions for evading duty on spirit and 27 successful prosecutions for evasion of duty on mixed excise goods.

<i>Prosecutions</i>	<i>Spirits</i>		<i>**Mixed Excise</i>		<i>Total</i>
	<i>Successful</i>	<i>Unsuccessful</i>	<i>Successful</i>	<i>Unsuccessful</i>	
*2001–02	7	2	91	8	108
2002–03	21	3	34	28	86
2003–End December 2003	11	1	27	12	51

*Figures prior to 2001–02 are not available in this form

**Mixed cases include mixed alcohol or alcohol with other excise goods

20. Prosecutions figures alone are not an indication of Customs success in tackling spirits fraud. There are many other sanctions available to Customs in detecting spirits fraud, including:

- seizure (and non-restoration) of the goods. In 2001–02 Customs seized 2.1m litres of spirit, 2.6m litres of beer and 612,000 litres of wine;
- seizure of the lorry carrying the goods;
- detection of frauds successfully perpetrated and follow up action of assessment and robust recovery of revenue evaded. In 2001–02 Customs identified 2.5m litres of alcohol that had been successfully diverted on to the UK market;
- withdrawal of approvals or registrations. In 2002 during one investigation alone, ten registrations and three warehouse approvals were withdrawn.

THE IMPACT OF TAX STAMPS

21. Customs' view is that it would be significantly easier to identify those selling illicit product if tax stamps were introduced. Tax stamps would mean that retailers and the public would know that they were purchasing illicit product and would be conscious of the risks associated with the selling and drinking of illicit product.

22. Tax stamps would be applied at any point prior to the release of goods for consumption. This means that goods destined for the UK market must be tax stamped and be present on any bottle of spirit bought off the shelf in the UK.

⁵ *The collection of excise duties in HM Customs and Excise*, Report by John Roques and the Response by Her Majesty's Government to the recommendations in the report, July 2001.

23. Our estimate is that tax stamps will have a revenue benefit of £160 million in their first year of implementation, 2006–07. A note explaining this estimate (reproduced from one of the information papers provided to the industry in January) is attached at Annexe A.

24. The main risk to the integrity of a tax stamps system is counterfeiting. If tax stamps are implemented, Customs would seek out the most appropriate anti-counterfeit technology in designing tax stamps. Our assessment is that counterfeiting is not likely to be achieved on a large scale.

25. Customs has always recognised that a disadvantage of tax stamps is the compliance costs which they would impose on the industry. The size and distribution of compliance costs would depend on the impact of the measures taken to implement tax stamps, and on any measures the Government may introduce to offset that impact.

26. PBR03 stated that, should tax stamps go ahead, the Government would consider changes to the duty deferment scheme and a spirits duty freeze for the remainder of this Parliament. Our current discussions with the industry are covering among other things the impact of compliance costs and possible offsetting measures. A full Regulatory Impact Assessment for tax stamps would be published before or alongside publication of the Finance Bill.

ALTERNATIVES

27. As stated above we have had several rounds of consultation in recent years, both formal and informal, with the alcohol industry on ways to reduce spirits fraud. PBR03 gave the industry a further opportunity to put forward any alternative proposals which would be similarly effective to tax stamps in tackling fraud. For the purposes of this and the previous consultations, the industry has worked principally through the mechanism of the Joint Alcohol and Tobacco Consultation Group (JATCG), which comprises a wide range of alcohol industry trade association and company representatives. In discussions since PBR03, the JATCG has had sub-groups on fraud estimates, alternative measures and compliance costs/design of tax stamps.

28. The JATCG has responded to the PBR invitation by developing a suggested new package of alternative measures. They are currently finalising details of the package for formal submission. Following several useful discussions with the industry, Customs will consider these proposals carefully and give an assessment of their impact in our advice to Ministers in the run-up to the Budget.

David Hubbard
 Head of Excise Group,
 Business Services and Taxes

1 March 2004

ANNEXE A

HMCE Information Paper for JATCG meeting 12 January 2004

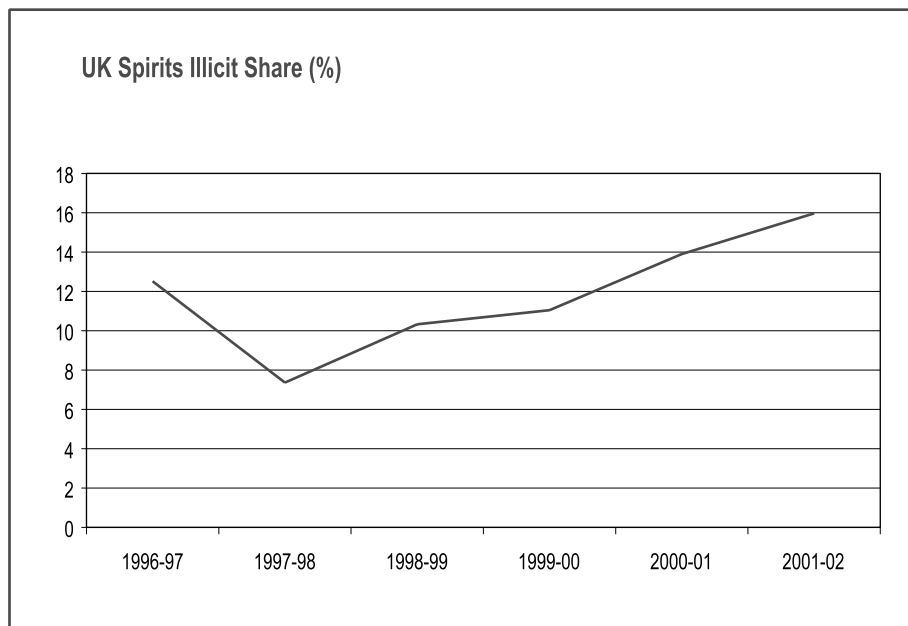
ALCOHOL STRATEGY COSTINGS: TAX STAMPS

This short note summarises the approach taken to estimating the revenue benefits from the introduction of tax stamps on spirits.

BASELINE

The table below shows our current assessment of the illicit market share in spirits. The chart shows progress over a longer period.

	1999–2000	2000–01	2001–02
Spirits Illicit Share (%)	11	14	16



For the purposes of costing tax stamps we have assumed that fraud remains flat into the future at around 16% of total UK consumption. This is consistent with the revenue forecast for spirits and produces more cautious estimates of the potential fraud prevented as a result of the introduction of tax stamps; if fraud is assumed to be greater, the potential nominal impact of a measure such as tax stamps will also be greater.

Total consumption levels in the future are estimated by assuming that our estimates of total consumption grow in a manner consistent with the growth in consumption assumed in the revenue forecast for spirits.

BENEFITS

Customs has concluded that the presence of a tax stamp will:

- Make the identification of illicit spirits much easier at the frontier, to the extent that tax stamps will normally be applied prior to export to the UK.
- Assist in the ready identification of non-UK duty paid product at the retail end of the illicit chain, and allow the successful prosecution of such offenders.
- Deter those involved in the handling of smuggled /fraudulent product, particularly at the retail end and especially if associated offences are introduced.

IMPACT OF TAX STAMPS IN TACKLING INWARD DIVERSION FRAUD

If tax stamps are required to be applied prior to export to the UK the impact on inward diversion will potentially be very significant indeed. The methodology used by Customs to estimate the scale of the illicit market does not provide a robust breakdown of the relative scale of different types of fraud. While Customs intelligence suggests that the fraud trends can change quickly (eg; in response to C&E activity), analysis of the intelligence from seizures and other operational sources suggests that inward and outward diversion are of comparable scale.

Tax stamps will not prevent outward diversion, but will make the wholesale and retail distribution of diverted product more difficult.

However, for reasons of caution we have not included any impact from tax stamps at the frontier. We only consider the following, second impact of tax stamps.

IMPACT OF TAX STAMPS ON SALEABILITY OF ILLICIT PRODUCT

Tax stamps will impact upon the saleability of illicit spirits by making it easier for Customs staff and the public to spot illicit product, and by deterring retailers from attempting to sell it. To assess the potential for tax stamps to restrict such sales, an “expert group” of Customs operational staff was convened. This was complemented by an exercise to canvass the opinion of individuals working on the alcohol assessment. The

split between “retailing” and “hawking” of illicit product and the scope for tax stamps to prevent it was considered. The following conclusions were drawn, which we have updated where necessary using the latest available intelligence or information:

- Illicit Spirits are supplied primarily (80%) through the licensed retail sector and less so (20%) by “hawking” through unlicensed premises. Customs also assess that—in line with the balance of spirits sales between the on and off trades—within the licensed retail sector the large majority of illicit spirits are sold through the off-trade.
- Tax stamps would make sales of illicit alcohol through the retail sector more difficult because the risk of detection would be significantly raised, as would customers awareness of whether they were being sold illicit product. The view of Customs’ operational staff was that tax stamps would prevent 70% of illicit sales through retail outlets. The impact upon hawking is likely to be smaller because consumers already know that the product they are buying is illicit. Tax stamps are therefore assumed to stop only 5% of sales made through hawking.

To add an additional element of caution to the assessment we have also assumed that a proportion (20%) of the reduced volumes in the retail sector are displaced into hawking.

TREATMENT OF VAT

We have assumed for the purposes of costings that VAT is recovered on any reduction in hawked product but that—for reasons of caution—we assume that it is already paid on product sold through the licensed sector and reduced illicit sales in that sector do not generate a revenue gain from increased VAT.

RESULTS

Assuming that the impact of tax stamps is felt in full from the start of 2006–07, applying the assumptions above generates additional tax revenues of £160 million over a full year.

January 2004

Witnesses: Mr David Hubbard, Head of Excise Group, Mr Derek Hodgson, Head of Analysis Division, Mr Tony Walker, Head of Fiscal Fraud Policy, Customs and Excise.

Q48 Chairman: Order. Order. Perhaps I should just say at the outset that it is very appropriate that we have Customs and Excise appearing before us, given that the first ever written reference to distilling in Scotland comes from the Exchequer Rolls of 1494, so taxes on distilling are not without precedent! Can I thank you, gentleman, for your attendance today. Before the Committee turns to specific questions, do you have anything you wish to add in support of your memorandum at this point?

Mr Hubbard: Thank you, Madam Chairman. I do not want to detain the Committee, so I will not make any comments to expand on our memorandum other than just to make two small points of process. Firstly, to give an update, at the time of submitting our memorandum (1 March), as the memorandum makes clear, we had not yet received the formal submission from the industry through the Joint Alcohol and Tobacco Consultation Group covering their response to the challenge that the Chancellor set in the pre-Budget report. We have just received that formal submission on 5 March and we are in the process of analysing that. So that is a small step forward in the process. The second point, Madam Chairman, though I am sure you and the Committee will be aware of that, with the Budget coming up on Wednesday of next week, while we will do our very best to answer all questions to the extent that we can, there may be an element of constraint to the answers we can give because of the proximity to the Budget. Thank you.

Q49 Chairman: Thank you very much. There is clearly no difference, in principle, between Customs and Excise and the Scotch whisky industry over the need to tackle fraud. However, the two sides appear to be in disagreement over the best way to achieve this. Could you summarise why you believe that the best way to combat fraud is by the introduction of a tax stamp?

Mr Hubbard: I think that decision is of the sort that will be for ministers to take in the budget, but perhaps I could give a little bit of commentary over why Customs and Excise advise ministers that tax stamps may be effective and certainly effective in a way which is in contrast to the ways that the alternative measures put forward by the industry would work. Uniquely, among all those measures, it is tax stamps that would change the nature of the market which those engaged in spirits fraud face. It would introduce a clear visual indicator on bottles of tax-paid spirits, wherever they are put out for sale in the United Kingdom, to show that spirits has been duty-paid. The spirits fraud arises because of the nature of the EU determined duty suspension arrangements largely. Most spirits fraud is perpetrated through inward or outward diversions, as the Committee understands, and tax stamps would change the nature of that market and so make spirits fraud more difficult and less profitable; and it will be a judgment for ministers to make in the Budget over whether that is a sufficient characteristic which makes tax stamps the only appropriate measure or a measure which it is still justified in taking in the face of possible alternatives.

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Q50 Chairman: You will be aware that the Scotch whisky industry, the Scottish TUC, CBI Scotland, the Scottish Council for Development and Industry are all against the introduction of a tax stamp and, internationally, the USA abolished them about 20 years ago, Germany, Belgium and Norway have abandoned plans to introduce such stamps. Why then, in the face of all this, is Customs and Excise so clearly in favour?

Mr Hubbard: Madam Chairman, I think it is safe to say that tax stamps are no easy option. They are not a panacea for reducing fraud, and the way that Customs and Excise and this Government have approached the introduction of tax stamps is not to leap to tax stamps as the first or only available solution. We have been through a series of consultations with the industry, both formal and informal, as the Committee will be aware, on tax stamps and have certainly looked exhaustively at alternatives which might have an equivalent effect. It is plain, and the Government have acknowledged this—the Chancellor made it very clear in the pre-Budget report—that tax stamps has a particular disadvantage in terms of the compliance costs that it would impose on the industry and, therefore, neither Customs and Excise nor any responsible government is likely to impose tax stamps lightly. However, it is our judgment, as I said at the outset, and a judgment which we think is backed up by our enquiries of other international administrations, that tax stamps can have a significant effect on reducing fraud. You have mentioned, Madam Chairman, a number of countries which have discontinued or thought twice about tax stamps: there is equally a long list of countries which have decided to introduce tax stamps or are maintaining tax stamps even in the light of representations from industry, in particular, about the costs that they impose. We have been in contact with around 20 of the 40 countries which maintain tax stamp systems and all of those consider that tax stamps has a beneficial effect in terms of either maintaining quality or reducing fraud. So there is plainly an area of disagreement between us and the industry and those bodies that you have mentioned about the effectiveness of tax stamps, but we think that there is considerable evidence that supports our view that tax stamps will have a significant effect, though clearly it will not be a panacea, it will not eliminate spirits fraud, it will simply, in our view, make a substantial in-road into that fraud.

Q51 Mr Weir: Can I ask you these two questions. As I understand it, when John Roques investigated alcohol fraud he said that outward diversion had been cut back considerably by tightened warehouse controls and the introduction of physical checks. I wonder why that, together with what the industry is proposing, is not considered a more effective solution than having a completely new system of tax stamps with all the costs that would be involved with that?

Mr Hubbard: I think the answer to that is that, once any of our controls are eluded there is a straightforward and clear profit incentive for the

fraudster at the retail end of the market. Once they have been able to get hold of duty unpaid spirits, whether it is inward diversion or outward diversion or a small element is still smuggling, there is nothing really to prevent them from getting that into the legitimate retail markets. Our operational assessment is that about 80% of fraudulent spirits are sold through legitimate retail environments, and there is no current real inhibition to that.

Q52 Mr Weir: Following on from that, the industry tell us that, first of all, if the Revenue, the Customs and Excise, are correct in their figures, just about every single bottle sold in an independent would have to be fraudulent or evading duty, and that seems incredible, the number. Secondly, is it not case that each bottle of spirit already has a lot number on it, so it can be presumably traced back to where it was made, when it came out of the warehouse, distillery, whatever. Has that been used for prosecutions for those who are allegedly making huge money from this illicit business?

Mr Hubbard: So-called “track and trace mechanisms”, like lot numbers, do have some marginal use to Customs and Excise in attempting to track back non-duty paid spirits to source, but the supply chains can be extremely convoluted. They can go into and out of the country, consignments can have changed hands many times before reaching the final point of sale and it is very difficult and extremely resource intensive for us to be able to do that supply chain tracking back and to gain sufficient evidence to make a prosecution. In fact, that very rarely happens because it is difficult to attach, in particular, the guiding mind at the centre of one of these major frauds to a bottle at the retail end which simply has a lot number attached to it.

Q53 Mr Weir: I may be being stupid here, but I am not clear as to how tax stamps is going to change that very point. How do you get to the guiding mind? I mean, if there is the odd retailer with a couple of bottles that is one thing. Presumably, from what you are saying, there must be a huge, “mastermind” may be the wrong word, but behind large scale fraud. How are tax stamps going to be any more successful than lot numbers in tracing back to that mastermind figure, if you like?

Mr Hubbard: Our assumption, and it is not just a guess, it is based, for example, on our operational experience of introducing fiscal marks for cigarettes, is that the introduction of a clear marker like a tax stamp will change the receptiveness of retailers and, of course, consumers to an illicit product. If it is not tax stamped everyone will know, subject, of course, to the possibility of counterfeiting, which I am sure we will revert to later in the discussion, but everyone will know that if it has a tax stamp it is tax-paid, if it does not have a tax stamp it is plainly illegal; and that changes the whole environment, the whole nature, of the retail market which the fraudsters are facing.

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Q54 Mr Carmichael: I think Mike has already touched on it. As far as I can see it, you have made reference already twice to the nature of the EU determined duty suspension system, and I think you are absolutely right, I think that strikes at the heart of it; but surely the only difference that tax stamps will make is that you then have a forged tax stamp that goes on the bottle when it comes out of the duty suspended warehouse and you are not actually going to solve the old problem, you are just going to create a new one?

Mr Hubbard: Counterfeiting is certainly one of the operational risks that we will have to counter in the introduction of tax stamps. We are very conscious that that will be a risk, because evidently there have been counterfeit tax stamps in other markets. We do foresee that we can contain that risk. We do think there will be some attempts to introduce counterfeiting—it would be unwise to make any other assumption—but both through the technological sophistication of the tax stamps that we would want to introduce and our general experience of countering fraud gives us some confidence that we would be able to contain attempts to counterfeit at a level which does not call into question the general effectiveness of tax stamps as a revenue raising and fraud reducing mechanism.

Mr Carmichael: I think we are coming back to counterfeiting later. We can explore that then.

Q55 Mr Duncan: Can I push you on this idea of lot numbers. I think the average man in the street simply does not understand why, if Customs and Excise are saying, as you say in your submission, that approximately one in six bottles in the UK has had tax evaded on it, you cannot go into a retail outlet, take the lot number off the bottle, which by definition has the manufacturers name on the front of it, and track that back to see, from the evidence provided by the company, as to who was the first purchaser of that bottle. I think the man in the street simply does not understand why that is not possible?

Mr Hubbard: We do that, but, as I said before, it is very resource intensive to do. The supply chains are long and complicated and it is very difficult to get evidence through that route.

Q56 Mr Duncan: Forgive me. If we are talking about, for example, a bottle of Glenfiddich where there is a lot number, I think you will find that the manufacturer of Glenfiddich will be only too delighted to cooperate with you in terms of supplying the information that you want as to who was the first purchaser of that bottle of whisky when it left the distillery. Why is that not possible?

Mr Hubbard: It is possible. We regularly—

Q57 Mr Duncan: You said it was resource intensive. Why is it resource intensive?

Mr Hubbard: It is possible for us to establish from a manufacturer in the UK who the first customer was to whom they sold a product which has a track and trace element like a lot number. That is essentially where the trail can start to get very complex. We would then have to try to track where it went after

the first customer, which the producer may have no knowledge of. As I say, some of these frauds are very complex, deliberately so, in terms of their paper trail and the exchanges that happen along the way, and it is very difficult to make an accurate retrospective picture of a particular supply chain.

Q58 Mr Duncan: Can I ask, how many such enquiries have Customs and Excise made in the last 12 months through that route of going through a lot number?

Mr Hubbard: We make regular enquiries, for example, through our National Discreditation Team at the Frontier, who would be in touch with manufacturers. I could not give an exact number.

Q59 Mr Duncan: Is there a member of staff in Customs and Excise who is dedicated to that task?

Mr Hubbard: That mechanism is not especially effective in us being able to counter fraud, for the reason that I have given, that although we would be able to track where that bottle was first sold from and to—and this is assuming that it was produced by a UK producer and it is not simply an imported product, because it is a very complex market we are dealing with—but, as I say, that is not a productive routine exercise for us.

Q60 Mr Duncan: I want to talk about the imported product in a minute, but can I ask just on the scale of it. Your latest assessment in your submission is £600 million of tax. Can you tell us how that figure has changed in the recent past? In the past five years how has that assessment fluctuated?

Mr Hubbard: Perhaps I can here invite one of my colleagues, Mr Derek Hodgson, who is Head of our Analysis Division, to comment on the run of figures in recent years.

Mr Hodgson: We have been publishing estimates for the scale of fraud for the last three years now. We have published three annual documents, the most recent one at the time of the pre-Budget report last autumn. Our latest estimate is for 2001–02, when we estimated the scale of fraud at £600 million, 16% of the market share. The trend has been upwards from 1997–98, when it was 7% of the market, or £200 million in terms of duty and VAT evaded. I can go further back in time if you wish.

Q61 Mr Duncan: Can I ask how you get to that assessment from a statistical point of view? Is that done by a sampling exercise, or is it a case of aggregating production and taking off exports? How do you get to that figure?

Mr Hodgson: What we do is we try, firstly, to obtain an independent estimate of the level of total spirits consumption for the country. We do that by using survey data.

Q62 Mr Duncan: Which is relatively static?

Mr Hodgson: These are on-going surveys run each year by the Office of National Statistics.

Q63 Mr Duncan: In overall market terms, there is no significant increase or decrease in market size?

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Mr Hodgson: No. The total consumption has been growing. In the surveys that we have been using, as I say, from the Office of National Statistics, there has been a very substantial growth in total consumption—that would be both legitimate and illegal spirits. There has been a fairly substantial growth over the last 10 years. Yes. Having then obtained the estimate of total consumption, we simply subtract the legitimate elements, which would be the clearances from warehouses which we know about and things like legitimate cross-border shopping. The remaining residual is, by definition, the estimate of fraud that we use.

Q64 Mr Duncan: How do you assess illegitimate cross-border shopping?

Mr Hodgson: Illegitimate cross-border shopping would come under the category of fraud. It would be grouped in there. To distinguish between legitimate and illegitimate, we essentially take a cut-off point based on a quantity that it is reasonable for somebody to be bringing back.

Q65 Mr Duncan: Can I ask, what other countries have a tax which appears to discriminate against their own home-produced products in favour of, for example, imported products, like imported limes?

Mr Hubbard: I am not sure I understand the question, because I would hope that it would be none: because if you had a system that discriminated between imported product and home-produced product, you would be likely to be creating a trade barrier. I am aware that some countries' tax stamp systems have been challenged on those grounds, not because tax stamps in themselves constitute a barrier to trade, but because they have been applied unequally to home-produced and imported products, if that was the question.

Q66 Mr Duncan: You referred in your earlier questioning to other countries which had different experiences. Can I ask, has Customs and Excise sought the views and advice from your colleagues overseas about the introduction of such a tax stamp? Take, for example, the United States, beer and alcohol. Have you discussed with them their experience and, if so, what would be the likely experience were we to introduce it?

Mr Hubbard: Yes, certainly. As I said earlier, we have had some contact with a range of countries, perhaps 20 in all, on their general experience of tax stamps. What that has led us to believe is, firstly, that there is a consensus in those countries that such systems are useful. Plainly, there is a strong risk of counterfeiting in some of these countries. Some have been very frank with us that sometimes the permeation of counterfeiting is linked to administrative integrity in those particular countries. In others it is perhaps a factor of the technology built into the stamp. Stamps range greatly in terms of their technological sophistication from simple paper strips to more sophisticated tax stamps, and we would certainly be looking, in further discussion with the industry, if ministers

decided that we would go ahead and implement tax stamps, to be introducing a technologically sophisticated version of stamp.

Q67 Mr Carmichael: Can I take you back to your calculation of the total consumption. If I have read your submission correctly, you have based it on figures drawn from the Family Expenditure Survey and the National Food Survey. As I understand it, they are householder completed surveys. Is that correct?

Mr Hodgson: Yes.

Q68 Mr Carmichael: It is not something that is done by any sort of objective analysis. It is all done by the householder filling in a form and ticking boxes, or whatever?

Mr Hodgson: That is correct.

Q69 Mr Carmichael: And that is it. That is your only source of data?

Mr Hodgson: That is the source of data that we use for the calculation, yes.

Q70 Mr Carmichael: That is not something which is specifically designed to get at the truth of the market size, is it?

Mr Hodgson: It is asking people about what they have purchased, consumption, over a specific period of time, and that does seem to me to be trying to get at the scale of consumption, yes.

Q71 Mr Carmichael: That is a much wider survey than just this, is it not?

Mr Hodgson: Yes, it asks them in general about their expenditure on food and other things.

Q72 Mr Carmichael: What you need to ask the retail industry themselves is the size of their sales?

Mr Hodgson: Asking the retail industry themselves about the size of their sales would not tell one anything about the scale of fraud, because it is unlikely the retail trade would tell us were they involved in fraud.

Q73 Mr Carmichael: What I am suggesting to you is that if you want to get an accurate figure of what total consumption is, surely you want something against which you can measure the accuracy of the data that you have collected from these surveys. Surely the obvious way of doing that would be to go to the retail industry, to go to the spirits retailers through bars and hotels and whatever else themselves. You are not doing any of that, are you?

Mr Hodgson: There is market information collected by various commercial companies which we do purchase which do give us an indication of what retailers report they are selling. Yes, we do have that available.

Q74 Mr Carmichael: So you use that as a benchmark for comparing the Family Expenditure Survey and the National Food Survey, do you?

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Mr Hodgson: It is relevant, but it would not directly tell you whether the information from the food survey was correct or not, because, by definition, the information from retailers would not be including fraudulent sales of spirits, at least it is extremely unlikely that it would do.

Q75 Mr Carmichael: Then again, you say yourself, the raw data are “smoothed”, whatever that means, in order to reveal the underlying trends. So it suggests to me that you do not think that the data you are getting from these two surveys is correct anyway?

Mr Hodgson: No, the survey data of its very nature, because it is based upon samples of limited size, can, as it were, bounce around a bit from one period to the next. By smoothing it effectively what you are doing is you are aggregating the sample over a slightly longer period of time, and that is hopefully giving you more accurate estimate of the trend.

Q76 Mr Carmichael: Then you say: “Household surveys are typically characterised as under-reporting. In order to overcome this, Customs assume that in 1992 there was minimal smuggling in the cross-border shopping and that overall consumption in that year was equal to UK duty free consumption and duty free purchases.” What does that mean?

Mr Hodgson: It means that if you were to take information from only surveys and assumed that that was a correct estimate of the total level of consumption, it would be very likely you would be using a gross under-estimate, because people do not tell the truth totally to these surveys, they underestimate their actual level of consumption. So what we have tried to do is to say, “Is there any way, as it were, we can calibrate these survey results against a point in time when we are fairly certain we know what the total level of consumption was?” The way we have tended to do that is to say that back in the early 1990s, before the emergence of large-scale fraud, it is fairly certain that the amount of clearances that Customs and Excise were recording was broadly equal to the total level of consumption. If we know that, we can then, as it were, calibrate the survey results back to that point in time and up-rate them to give a realistic estimate of the total level of spirits consumption running forward throughout the 1990s up to now.

Q77 Mr Carmichael: The National Audit Office is looking at this at the moment?

Mr Hodgson: They are.

Q78 Mr Carmichael: Do you know what model they are using?

Mr Hodgson: We have given them details of our model, and I understand that the SWA¹ have also given details of the methodology and the assumptions they have been using, and I think they are looking at both of those.

Q79 Mr Carmichael: So all they are doing is analysing your methodology and the SWA’s methodology. They are not trying to come up with the figures themselves?

Mr Hodgson: They have been asked to look at whether the two sets of estimates can be reconciled, and that, as I understand it, is what they are doing.

Q80 Mr Weir: Going back to what Mr Hubbard was saying in answer to Peter, I do not understand what you are saying about the discrimination aspect: because there must be a reason why it is attractive to fraudsters to divert whisky from Europe into the UK. Presumably it is because of differences in duty. Is that the case?

Mr Hubbard: Money is at the route of most crime, and one would have to assume that the profit margins available to the fraudsters in this area are a key area of attraction for them.

Q81 Mr Weir: So that is a very fair way of saying it, because the duty is less on the Continent than it is in the UK, so they can make money by bringing it in from Europe?

Mr Hubbard: There are a range of factors that affect the way in which fraudsters target particular markets, but money and the profit margin have to be at the core of those.

Q82 Mr Weir: But if it is legitimately produced whisky coming out of a distillery, going somewhere and coming back in again, or being diverted in some way, it must be because they can sell it cheaper because of not paying the duty in some way. It must be to do with duty differences, surely?

Mr Hubbard: Certainly if you were a fraudster and you were choosing where to divert your product, you would probably choose to divert it where the profit margin was greatest.

Q83 Mr Weir: You are not going to say, yes, obviously, so we will move on. When you were talking about the lot numbers, you talked about the difficulty there was, it was resource intensive to trace them back. What are the resource implications for Customs and Excise of the strip tax? I understand from the American experience that in the United States there were Customs officers located in every distillery 24 hours day, 365 days a year, through all shifts, to check what was being done. Is that going to be case in the UK, or how are you intending to operate it?

Mr Hubbard: Yes. In the UK also, not so long ago, we had excise officers in distilleries round the clock, but the nature of our controls would change in a tax stamps environment. We would naturally be redirecting some of our resources to looking at retail outlets based on intelligence and risk profiles, and in the absence of tax stamps it would be much easier to make because there would be a range of penalties introduced for those dealing in non-tax stamp products to tackle that end of the market.

¹ Scotch Whisky Association.

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Q84 Mr Weir: But the trade have put forward an alternative proposal for authenticating inward movement documents and returning them to the country of origin via UK Customs and also intelligence-based interception of inward movements. Would that not be a better way to prevent fraud? I am still not clear how tax stamps would make all that much difference, given that lot numbers do not seem to have made any difference, and that there would clearly be some sort of counterfeiting of these tax stamps. So, unless you have the intelligence to intercept things coming into the UK or being diverted from the UK, I am not sure you are going to make any real progress with this?

Mr Hubbard: Part of the advantage of tax stamps is that, setting aside the way in which Customs and Excise would enforce the new arrangements, it would simply change the receptiveness of the market to illicit product, as I have already explained, or tried to explain, several times. So that is what creates substantially the anti-fraud and revenue raising effect.

Q85 Mr Weir: You keep saying “the receptiveness of the market”, which suggests to me the real problem, as you see it, is at the retail end of the market, not at the production end of the market; but it is the production end of the market that is going to be hit by the additional costs of this stamp. Is it not the case that, if the real problem is in the retail end, more resources should be going in to tackling the retail end, perhaps using lot numbers or some other way to track them back. I would have thought, for example, if a lorry load is coming in it will be from the same or a similar lot number, and it would have been distributed in an area of, say, Central London, and you would have half a dozen retailers, if your figures are in any way correct, and can trace back the distributor from there. You mentioned you go back to the producer, but surely, it seems to me, you should be looking back from the other way is the real problem?

Mr Hubbard: That does not happen at the moment, plainly, if our assumption on the level of fraud is correct. It is very difficult even for legitimate retailers acting in good faith sometimes to know that they are receiving a UK tax paid product because it looks no different to UK non-tax paid product.

Q86 Mr Weir: Is that not a bit naïve: because I would have thought anybody running a business, a small shop or whatever, would buy their product from a recognised distributor. If you are buying it from a man who comes round in a white van, then you know you are buying an illegal product, there is no misapprehension, and you are committing a crime, reset as we say it in Scot’s law, or whatever. I just do not understand why there could be any misapprehension of someone buying illegal drink?

Mr Hubbard: Yet, when Customs and Excise, for example, did a recent exercise in the London area and visited 300 retail premises, we found illicit spirits in nearly half of those.

Q87 Mr Weir: Given that the industry are putting forward proposals, as I understand it, with the backing of the warehouse industry for more control both at the production and the warehousing end of it, surely, if that is the case, you cannot be suggesting a legitimate distributor is distributing this stuff illegally. Why is this not being concentrated on? Why are you not concentrating on, if you like, the white van man who is clearly taking the stuff around and selling it to the small shop? They must know what they are doing on their own premises?

Mr Hubbard: In terms of “white van man”, which we often take to mean, for example, the cross-channel passenger smuggling, we have made significant attempts to bring that down, and our analysis is that that particular problem, including the spirits, has been brought under control, but it remains the case, in our view, based both on our gap analysis and on our operational experience, that there is large-scale permeation of the legitimate retail market by non-tax paid spirits.

Q88 Mr Weir: That is not really—

Mr Hubbard: Can I move back to—. You ask whether the industry’s alternative suggestions would make comparable inroads in this regard, and perhaps I should make a general comment about the industry’s package of alternative proposals, if I may, Madam Chairman. As I said at the outset, the Joint Alcohol and Tobacco Consultation Group has put forward formally to ministers a package of 17 different proposals which it suggests are an effective alternative to tax stamps. This is a slightly different package to the one that the Scotch Whisky Association presented to the Committee last week, but many of the elements are the same. We are currently analysing that package. It is a well-intentioned package of alternative measures which, in our view, would go somewhat further than what we have in place currently to make outward diversion fraud more difficult and, in some respects, to help also with inward diversion of fraud. What we are in the process of doing and will advise ministers on is, and there will be a great deal of judgment involved here, just how much fraud would be reduced by this package of alternatives. I would have to say that, although the alternatives build on what we have now—they are additional to what we have in place at the moment—they are not wholly additional to what we have planned. There were other measures that the Government announced in the pre-Budget report that would be taken to reduce opportunities for fraud which are already in the pipeline. To a small extent the alternative measures include or build on some of those. So we will have to make for ministers a clear assessment of the benefits the package would bring.

Q89 Mr Weir: Moving on from that then, the industry, when they were before us last week, claimed that their proposals would deliver more benefits and quicker than the tax stamp would. What is your reaction to that?

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Mr Hubbard: Firstly, on a factual point, the Joint Alcohol and Tobacco and Consultation Group has not made the same claim in its formal submission, certainly on the amount of revenue that the alternative measures might bring in. It has said that this would be an effective alternative to tax stamps but is really leaving the judgment to be made on how much revenue that would bring in; and it will be difficult, it is proving difficult, to analyse that exactly because there are a large number of individual measures in the package and a judgment will have to be made over whether those are wholly additional, whether the sum is as great as the parts, or greater than the parts, or less than the parts. It depends which aspects of fraud are being addressed by each of the measures and also what the potential might be for that fraud to be displaced into other areas. So, as I say, there is no doubt that this would deliver somewhat more than we have at the moment and is a valuable and well-intentioned package, and certainly we, Customs and Excise, strongly welcome cooperation with the legitimate industry—it is valuable in our work—but we will also have to be clear in our analysis of what the effects would be; and, because of the opportunities that are available within EU rules on movement of duty suspended product within the European Union, even if cooperation with the legitimate trade were raised to the fullest possible extent, it is unlikely that that would eliminate the scope for fraud, particularly when, once these controls were evaded, the market would remain unchanged. Once duty suspended product had been diverted, it could still go into legitimate retail markets at nearly the same profit margin as a legitimate product.

Q90 Mr Weir: But no system is going to completely get rid of fraud. Even the tax stamp system will not completely. There are ways round any system?

Mr Hubbard: That is right.

Q91 Mr Weir: The industry is offering you, as I understand it, very close cooperation right from production, distribution, down to retail, I suppose; but are the three, the production, distribution and Customs and Excise working closely together, not a much more effective way of dealing with the supply chain problems rather than a tax stamp?

Mr Hubbard: That is essentially the question which ministers will make a judgment on in the Budget.

Q92 Chairman: Can I go back. You said a moment ago that there was an exercise carried out where you visited 300 shops in the London area. How often would such an exercise happen?

Mr Walker: Madam Chairman, thank you. This was an exercise that was run over a six month period, and the results that you have just quoted were from that particular exercise, but it is a technique which, of course, can be used at any time, not only as an exercise but also as one-off visits led by specific intelligence.

Q93 Chairman: How often would it have been done on these particular 300 shops?

Mr Walker: As I understand it, it was one visit to each of the 300.

Q94 Chairman: So if I was a small independent retailer, it would be a pretty good bet that I could buy from the man in the white van without very much danger of Customs visiting me. Is that right?

Mr Walker: Not necessarily, Madam Chairman. Those results were merely the results of one particular exercise. There are on-going initiatives, particularly in specific cases led by intelligence, and, of course, the independent retailer has no idea when he will next get a knock on the door.

Q95 Chairman: If he has only had one visit, it is a pretty good bet that he is not going to get too many, is it?

Mr Walker: There are a number of retailers that do get a number of visits, but they are not included in that particular exercise.

Q96 Chairman: On that exercise, you say that there were 143 seizures of spirits from these shops. How many prosecutions were there from that?

Mr Hubbard: The process of responding to that exercise is still on-going, but I would foresee there would be unlikely to be many prosecutions as a result of that, because although all the product was seized, you would have to show a degree of complicity and knowledge and that becomes, as I said earlier, a very intensive process.

Q97 Chairman: So my bet on being a small independent retailer buying from the “white van man” has just increased the chances of not being prosecuted: because I have now had the visit, which is highly unlikely—I have only ever had one—and now I am not going to be prosecuted anyway. It is a pretty good chance to take, is it not? Is it the policing of the current arrangements that we are getting wrong, and should we not be looking more to policing what we have in place rather than looking for a new system? Do you not have enough officers to do the job you should be doing?

Mr Walker: The seizures in those particular cases were obviously in cases where we could prove that the stock was non-duty paid, and that obviously is at very heart of the discussion. That is not to say that in the other 50% of visits there was no non-duty paid stock on the premises, it is just that officers could not prove that, and, of course, with tax stamps that would make that particular exercise a lot easier.

Q98 Mr Carmichael: Can I follow up on your question, Madam Chair. Mr Hubbard, you said there were no prosecutions because you would require them to demonstrate guilty knowledge. Is that right? I always understood that Customs and Excise management always asked for strict liability offences.

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Mr Hubbard: I said that I foresaw a limited number of prosecutions from that exercise. I think that is a point that I would need to check and come back to the Member on.²

Q99 Mr Carmichael: But why would you foresee . . . The law as has been constructed by Parliament puts all the advantages on your side as the prosecuting authority. It says it is a strict liability offence. If you are selling this stuff and it is not duty paid, you are guilty. If I am wrong about this, I apologise, but, Mr Walker, you work on the enforcement side, do you? Am I correct?

Mr Walker: If I may say so, I think—I do not think that is absolutely right, because in a number of these cases the retailer would have unwittingly purchased alcohol which Customs were subsequently able to show was not duty paid. Therefore it would be very wrong, of course, to take any sort of action in those circumstances. The retailer could have bought it in good faith, it may not have been from a supplier in a white van, it could have been from another business which appeared legitimate, and so on.

Q100 Mr Carmichael: What is the actual situation here? Surely you only uncover the truth of the situation if you investigate it properly and prosecute, and it is then for the shopkeeper to put their defence in to say, “I bought it from this particular company”, or, “I bought it from this man who came to the back door and said, ‘Do you want a case of whisky?’” You are not doing that, are you?

Mr Walker: I am sure in this particular . . . I am afraid I do not know the details of every single one of the 300 visits, but I do know that that would be one of the methods employed by the officers to establish whether the source of the spirits was in fact duty paid or non-duty paid. So enquiries would, of course, have taken place following the visits to establish those facts.

Q101 Mr Carmichael: Of the 143 that you did actually seize illicit non-duty paid product from, how many of them did you check the lot numbers on?

Mr Walker: I am afraid I do not have that information to hand.

Q102 Mr Carmichael: Could you get it to us?

Mr Walker: We could certainly try and establish that, yes.³

Mr Carmichael: Thank you.

Mr Weir: Alastair has covered what I was going to cover, but I still do not understand. You keep going back to “They may have bought unwittingly.” I cannot see how anyone can buy unwittingly non-taxable alcohol. Most suppliers would buy from a recognised distributor and would have paperwork to back it up. Anybody who buys from someone, as Alastair says, who comes to the back door with a crate of whisky knows exactly what they are doing, and I do not see what else you need to proceed against them and trace them back to the supplier,

unless he just happened to have a knock at the back door. I just do not understand your problem with this, other than the lack of resources to actually do it.

Q103 Mr Carmichael: Can I move us on? Your submission, very helpfully, gives us two examples of duty evaded by instances of outward and inward diversion. On a very general level, first of all, allowing for the fact that a much greater number of consignments were involved in the inward diversion example, it would nevertheless seem to indicate that this is a greater problem than outward diversion, and certainly it would be more profitable for the criminal elements operating. Am I right, or have I got that one wrong?

Mr Hubbard: No, I think it is just that the two particular examples that we gave had greatly different revenue results. Our assessment is that perhaps outward diversion and inward diversion, and although the balance is constantly moving between the two and between a few other smaller forms of fraud, such as smuggling, they are broadly equal in their extent at the moment.

Q104 Mr Carmichael: Can you maybe just help me by talking me through the two examples that you have given? These are, I presume, actual working examples that you have taken from your own records or your own experiences in some way. Yes?

Mr Walker: Yes.

Q105 Mr Carmichael: To take the first example, the outward diversion, was this a Scotch whisky producer and how long ago, was it? Can you tell me?

Mr Walker: If I could preface my comments on this particular case. This is a case which has yet to come to trial, and so, necessarily, I have to be very guarded in the details that I give to the Committee at this time.

Q106 Chairman: May be you could help me with this then. If I am exporting whisky, for example, I presume I need an export licence. How is that policed? Do I just go along to the producer with a licence, pick up the load and disappear? Is it policed as it leaves the country, as the paper work comes back to the producer? You see I had occasion some years ago to look at the export of a drug called Temazepam, and what I found was happening was that I did not need to be a registered pharmaceutical warehouse to go along to the DTI and ask for an export licence. I got the licence, bought 500 million Temazepam tablets and nobody checked up to see where this was going. In fact, it was going to back into the streets of the UK. Does the same thing happen with spirit?

Mr Hubbard: To take these examples—I do not know whether it will be a good bridge into the examples themselves, Madam Chairman—if you are to be involved in moving a duty suspended product within the European Union, then you would need to be approved by Customs and Excise as an excise warehouse with a specific approval for that purpose; and if you were exporting to EU countries under duty suspension, you would only be able to do that

² Not available at time of publication.

³ See Ev 41

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to entities in those other counties who had equally been approved either as tax warehouses or as so-called registered excise dealers and shippers in the UK. There is a prescribed form of paper work that has to accompany each movement of duty suspended goods and prescribed records that must be kept, and so on. So it is, at least in outline, a regulated market. Nevertheless it is one—

Q107 Chairman: The records are kept, but how often are they checked?

Mr Hubbard: The checks are very regular on warehouse keepers. They are audit-based. So, although we do invigilate over a sustained period certain high risk entities involved in this commercial activity, in general we would be applying an audit-based approach where we would be visiting a warehouse keeper periodically and reviewing all of their records and procedures, but there are a whole range of checks that we can apply at any stage in the process.

Q108 Chairman: Is it once a year, once every two years, once every three months?

Mr Hubbard: It does vary, because we do already apply our controls in a risk assessed way. I do not think it would really be meaningful for me to give an average. Some warehouse keepers in particular receive very regular visits indeed.

Q109 Mr Carmichael: To come back to this first example, first of all. Surely you would agree with me that in this case neither the UK producer nor, indeed, the customs officer have been following best practice. Is that fair comment?

Mr Walker: Yes, that is fair comment.

Q110 Mr Carmichael: So, again, mindful of the dangers of fair prosecution and all rest of it, what has been done here to ensure that there is no future recurrence of this fraud?

Mr Walker: In this particular case—

Q111 Mr Carmichael: I mean, there must be scope for the producer himself to improve his own commercial controls here, is there not?

Mr Walker: As I understand it, the fraud in this particular example was—the fraudulent elements were removed from the producer and, you know, a series of sham companies were involved, and so on.

Q112 Mr Carmichael: The point I am making to you is it seems to me that this is an entirely preventable fraud, this first one. It is a fraud which could have been prevented and could still be prevented by a series of fairly basic commonsense commercial controls being implemented and enforced both by the producer and by yourselves. Is that not a fair comment?

Mr Hubbard: I think it is possibly, if I may be bold to suggest, a slightly unfair comment, in the sense that if everyone involved in the supply, purchase, transportation of spirits were honest and legal, then, sure, there would not be a spirits fraud problem. I

know that is a very simplistic response, but it is plain that not everyone is honest and therefore there is spirits fraud.

Q113 Mr Carmichael: I have made my living as a criminal court solicitor for long enough to know that not everyone is honest, but it would not be rocket science to prevent this, would it?

Mr Hubbard: To take the case of a UK producer who supplies in good faith to a customer that they think looks legitimate, they provide the paper work, they are consigning it to a tax warehouse that maybe they have established does exist in Portugal, as in this case. They get back some paper work which to their eyes looks genuine. They may feel that they have contributed in good faith to that process.

Q114 Mr Carmichael: You guys come in. You say, “We can check this”, and that is part of your regulatory function, is it not?

Mr Hubbard: And, indeed, we have picked this up. It is not realistic, I would suggest, that Customs and Excise can invigilate and regulate every single transaction that applies in the system. The scale of those is such that it would be prohibitively resource intensive to do that.

Q115 Mr Carmichael: No, but you could police a sensible system in partnership with the industry; and that is what is not happening at the moment. That is what the joint taskforce proposals are about. So why are you not giving them the chance first?

Mr Hubbard: That is a perception to which you are entitled and one, I think, with which we would disagree in the sense that we are attempting and we are using the partnership with those in the legitimate trade, which is, certainly on the production side, the majority of people. We are trying to get the maximum benefit out of that, but, despite that partnership, because of the evident opportunities that exist within the system as it is at present, it is our view, and our analysis of the fraud estimate suggests, that we are not successfully tackling that problem.

Q116 Mr Carmichael: Okay. Let’s leave that for the moment. Let’s take the inward diversion problem. Let me ask the “daft laddie” question first of all. I am sure there is a perfectly reasonable explanation for this, but how on earth is it possible that you have got Spanish, French and UK Customs involved here and yet they all manage between them to miss the fraudulent movement and sale of 400 loads? It does not look like a system that is working to me!

Mr Hubbard: No, I think that is almost exactly our point. If the system were working properly, then we would not need to be looking for additional measures to implement.

Q117 Mr Carmichael: So it is the regulatory system that is failing, and the solution for fixing that is to put the burden onto the industry. Does that seem fair?

Mr Hubbard: It is a system that is designed to facilitate the industry. Fundamentally, the EU duty suspended movement system is a trade facilitation

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mechanism because it allows the product to move in duty suspension without the significant costs that would apply to the industry if there were no such system. So, fundamentally, it is a trade facilitation system.

Q118 Mr Carmichael: We have already established, it actually works very well until you have the point of them leaving the system and entering the retail market?

Mr Hubbard: It is a system in which, if everyone were honest, there would not be a problem, yes.

Q119 Mr Carmichael: Is this a recent example that is still under investigation for prosecution as well, or is this done and dusted?

Mr Walker: No, I understand this is a live—

Q120 Mr Carmichael: This is a live prosecution as well. How was it detected? Are you able to say?

Mr Walker: I am afraid I do not have that information, how the case originated.

Q121 Mr Carmichael: If you were able to share that with us without prejudicing the conduct of the case it would be helpful⁴. Finally, to look at this question of partnership working with the trade, have the details of this fraud ever been shared with the legitimate UK trade before? Has it been discussed in as much further detail as possible with the trade to identify how it could have occurred and what could have been done to prevent it or detect it earlier?

Mr Hubbard: I would suggest that it is probably helpful to talk about this in general terms, if I may, and say that certainly through the Joint Spirits Fraud Taskforce, we have had very useful, in Customs' perception, discussions with the trade about the ways in which spirits fraud happen in the hope of better informing both sides so that in the future co-operation between the legitimate trade and ourselves might improve the way in which we tackle fraud.

Q122 Mr Carmichael: I take it that as a “no” then?

Mr Hubbard: You could take it as a “do not know” in this specific case and say, because it is one that is on-going, I could not say whether we had discussed that particular case at any particular meeting.

Q123 Mr Duncan: We talked earlier about counterfeiting. If I could just return to that, in particular. You recognise in your submission in paragraph 24 the main risk to the integrity of the tax stamp system which we are discussing comes from counterfeiting. Presumably you have heard of recent experiences in the Ukraine. Could you comment on them, particularly the impression that you may be being complacent about the possibility of counterfeiting and the effect that that might have on your entire system?

Mr Hubbard: If I may, I would prefer not to comment specifically on the Ukraine example. I did make some general comments about counterfeiting

and factors that might contribute to early availability of counterfeit stamps in my earlier remarks. As I said earlier, we fully acknowledge that counterfeit is a key risk of the tax stamp system. I do not know whether we are complacent about that risk or not. This is certainly an area where we would hope that continued good co-operation with the legitimate trade will help us to make sure that we have the least counterfeit prone tax stamp system that we can jointly devise.

Q124 Mr Duncan: What is the basis for your confidence: that you will be more successful in controlling counterfeiting than you have been in controlling the frauds which Alastair has been discussing?

Mr Hubbard: It is partly, perhaps, our experience with the introduction of tobacco fiscal marks, where, although some counterfeit packs have been found, we feel we have genuinely been reasonably successful in that area in countering that threat.

Q125 Mr Carmichael: Can you tell me what a fiscal mark in tobacco is—I do not smoke. What does it involve?

Mr Hubbard: It involves a printed statement UK duty paid, I believe—I do not smoke either—on the side of a packet of cigarettes that is sold in the UK market.

Q126 Mr Duncan: I am sorry, Mr Walker, you wanted to come in?

Mr Walker: Thank you. I wanted to add to the comments that Mr Hubbard made, I think, a couple of comments. Firstly, technology is improving all the time, and I think as we move into researching tax stamps, if that is a decision that the Government takes, then we would make sure that the tax stamps that were available were the best and the relevant security measures and counterfeiting measures.

Q127 Mr Duncan: You accept, of course, that improving technology is also going to deal with counterfeiters?

Mr Walker: Absolutely.

Q128 Mr Duncan: Indeed, it is perhaps developed by them!

Mr Walker: But I think the effect, of course, is that alcohol diversion fraud is currently relatively low effort and low risk and very profitable, and the need to source and then apply counterfeit stamps to bottles will make the fraud even more difficult for them, it will make it more risky for them and less profitable, so we feel that is an added benefit as well.

Q129 Mr Duncan: But is it not a fact that even counterfeiting of stamps is on a relatively small scale, and even in your submission you except that it is a significant risk, that it exceeds that. Even if it is on a small scale, will not the fact that it has been counterfeited at all indicate failure in the system?

Mr Hubbard: It would clearly be undesirable to have any counterfeit tax stamps in the system—that would not be an aim of the system. It is our

⁴ See Ev 42

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assessment that the level of counterfeiting on any sustainable basis would not be so significant that it would call into question the effectiveness of the system generally.

Q130 Mr Duncan: You must accept that the incentive is as significant if not even greater. The Scotch Whisky Association when they gave evidence last week brought in a box which was approximately the size of 200 cigarettes—I do not smoke so I would not know—with which the estimated revenue, in terms of value of the tax stamp, was £50,000. That is a significant incentive to someone to administer a counterfeiting system that can be done in a back yard anywhere in Taiwan, I would suggest, and outwith even the most significant technology with which Mr Walker has seen any difference?

Mr Hubbard: That is right. I do not want to give a second very simplistic answer after the one I gave earlier to Mr Carmichael, but counterfeiting, sadly, is also a fact of life, as we heard last week. Passports are counterfeit; currency is counterfeit; it is a fact of life for enforcement administrations to deal with, and we will be trying to deal with it. Equally, I do not want to rely on innuendo about covert aspects to tax stamps too much—I think enforcement agencies can easily do that—but there are a range of possibilities that we are looking at which we think would mean that the tax stamps that we would introduce and the way we would introduce them would be as counterfeit-proof as possible.

Q131 Mr Carmichael: You are relying on the parallel with cigarettes, which, forgive me, is completely new to me. What was the nature of the problem that this UK duty paid printed on the packet was designed to cure?

Mr Walker: It was to enable a non-duty paid packet of cigarettes to be easily identifiable from a duty paid packet of cigarettes.

Q132 Mr Carmichael: Right. But just talk me through this now. Was there a problem of people getting cases of cigarettes, printing their own Embassy boxes, filling them and putting them on to the market?

Mr Walker: There have been cases of counterfeit cigarettes, clearly in a counterfeit Embassy box, reaching the market, but the idea of fiscal marks was, as I say, for any member of the public or any retailer to be able to easily distinguish a non-duty paid product from a duty paid product, and in fact it has been very successful. There is very little evidence now of illicit cigarettes being sold through retail sectors.

Q133 Mr Carmichael: So this mark that is printed on the cigarettes, or on boxes of cigarettes, is it unique to that batch or that packet, or what?

Mr Walker: No, it is not.

Q134 Mr Carmichael: So it is completely different from what you have got in strip stamps?

Mr Walker: It is a fiscal mark as opposed to a tax stamp, yes.

Q135 Mr Carmichael: Which would be even easier to counterfeit! That may be happening and you just do not pick up on it?

Mr Walker: Yes. We have not come across any cases, as far as I am aware, where a genuine packet of cigarette has a counterfeit duty paid mark on it. There may be—

Q136 Mr Carmichael: You have found no genuine packet of cigarettes has a counterfeit mark on it. Does that mean you have found counterfeit packets of cigarettes that have counterfeit marks on?

Mr Walker: Yes, we have had cases of counterfeit cigarettes in a counterfeit packet with a counterfeit fiscal mark on it, but not a genuine product.

Q137 Mr Carmichael: It seems to me we are dealing with different problems here. Essentially you are dealing with a problem about perhaps a non-duty paid product being re-imported. Is that not the case?

Mr Walker: With cigarettes?

Q138 Mr Carmichael: Yes.

Mr Walker: With cigarettes it is a mixture of UK produced cigarettes exported and then re-imported and cigarettes manufactured overseas and imported.

Q139 Mr Weir: Is there not a much more fundamental difference in that, if I understand you correctly, this is a wee printed sign on your cigarettes box next to the one that says this is going to kill you anyway; but what you are asking the Scotch whisky industry and other people to do is to invest in a great deal of equipment to put an embossed stamp with a hologram on it. The cigarette manufacturer has to print the box anyway. Putting the wee sign on makes no difference to them whatsoever. It is going to be a vast new cost to the producers of Scotch whisky, for example, in these whisky strip stamps. So there is a huge difference between the two. Using that analogy, why can we not then just put a wee label on the Scotch whisky saying the duty has been paid?

Mr Hubbard: Yes, that is a good question. The answer to that is that, although the fraud problems can look similar, the nature of the tobacco, particularly the cigarette supply market and chains and the spirits market and chains are very different. For tobacco the number of suppliers is very small. For spirits the market is a great deal more complex, and the movement is more complex.

Q140 Mr Weir: I do not understand why. I mean, there are numerous brands of cigarettes made by a few large companies. In the whisky industry there are numerous brands but the vast number are made by a few large companies as well. I do not see where the difference lies?

Mr Walker: With cigarettes the cigarettes that are exported are not under the same holding and movement regime as alcohol, and a lot of the cigarettes that are smuggled back into the UK are exported outside the EU. There is not the network of warehouses and distributors in the UK as there are in the spirits industry. There is a much shorter chain in the UK, and, as I say, that is different to the spirits

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industry where spirits may pass through a number of warehouses in the UK before the goods leave the UK. It is a different distribution network.

Q141 Mr Carmichael: I think you are absolutely right. I think it is completely different, I just do not see why, given these patent differences, it should be the example that inspires you with confidence for the operation of a strip stamp in the whisky industry, or the spirits industry. Am I missing something?

Mr Hubbard: The key end that the consumer, the man on the street, the woman on the street, that we referred to earlier, going into a retail shop, would be able to see both in the case of cigarettes and in the case of spirits that those have been duty paid. For that effect it does not matter whether it is a printed mark or a tax stamp, it is the nature of the chain before you get to that that makes the tax stamp more beneficial than the printed pack mark for spirits.

Q142 Mr Carmichael: Except it is the bad people who supply it at the moment who might be bad enough just to counterfeit a stamp, a strip. That is the difference, is it not?

Mr Hubbard: Yes.

Q143 Mr Weir: Last week the Scotch Whisky Association recorded its instances of unscrupulous traders using the idea of tax stamps to disguise fake spirits. Are you not concerned that the introduction of tax stamps in the UK could actually exacerbate the problem of fraud as a tax stamp could make counterfeit goods appear genuine? It does take us back to your earlier point about the real problem in the retail end. If somebody is prepared to buy non-duty paid alcohol from some nefarious supplier, are they going to be that concerned as to whether it is real alcohol in the bottle or not?

Mr Hubbard: I think that is part of the risk of counterfeiting that we will need to think about. To what extent people would go to the trouble of securing genuine tax stamps and then applying them to counterfeit products, given the profit margins involved, I think, it is unlikely that that would be endemic.

Q144 Mr Weir: I understand from the examples quoted to us that it is. For example, Spanish tax stamps in the Philippines is a problem. It does suggest—you would not discuss the Ukrainian example earlier, but good examples as well, I believe, from Hungary last week. So it does seem to be fairly endemic in various parts of the world. What makes you think the UK is going to be any different?

Mr Hubbard: I think the comparisons with other countries can be difficult, because in some of those countries the tax stamp does secure a low element of tax. So perhaps the greater profit margin there is in producing the counterfeit spirit.

Q145 Mr Weir: But surely, if the tax stamp is for a lower amount of tax, it will be less of an incentive to do it than in an area like the UK where the tax stamp will represent a very high value of tax?

Mr Hubbard: But you are saying that the tax stamps would be genuine and the product counterfeit. So someone would have gone to the trouble of paying the UK tax but affixing it to a counterfeit product.

Q146 Mr Weir: If you are talking of bottled whisky that can cost in a small shop £15 perhaps, and your tax stamp would cost you, what, £5, or thereabouts. So there is £10 profit, 66% of the cost, and that seems a fair incentive to anybody who wants to do that?

Mr Hubbard: Yes, that is a fair point, and we ought to think carefully about that and talk to the industry about it.⁵

Q147 Mr Carmichael: Does that indicate you have not done this already?

Mr Hubbard: We have talked at enormous length, as I am sure you are well aware, to the industry over, in fact, a number of years now on all aspects of tax stamps. I think the specific question of the extent to which genuine tax stamps are going to be used on counterfeit product, although it is one to which they have referred and said that there is evidence in another countries to support that, we have not in fact discussed with them what that evidence shows. It is not an issue that our own discussions with countries that apply tax stamps—it is not an issue that has come out strongly.

Q148 Mr Weir: Should it not be an issue to consider before the Ministry goes to all the expense and trouble if the decision is taken to introduce strip tax stamps?

Mr Hubbard: As I say, every aspect of this question deserves closer examination, and in my view has received closer examination and extensive discussion with the industry. There will remain, there do remain, many areas where the industry's view of figures or effectiveness, even after these discussions, differs from ours.

Chairman: Moving on to joined-up Government, Peter.

Q149 Mr Duncan: Is a submission that the Scotch Whisky Association quoted figures for the number of people employed in that industry both directly and indirectly? Have you had discussions with other government departments, particularly the Scotland Office, the Department of Work and Pensions or the DTI about the possible impact on employment should another tax be imposed on the industry?

Mr Hubbard: We have had discussions with other government departments, as you would expect, including the Scottish Executive, about this measure.

Q150 Mr Duncan: Particularly the Scotland Office?

Mr Hubbard: Yes.

Q151 Mr Carmichael: Do you have the support of any other government departments for the introduction of a tax stamp?

⁵ See Ev 43

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Mr Hubbard: I think you might have to ask them, I suppose.

Q152 Mr Carmichael: They do not tell you?

Mr Hubbard: It is widely acknowledged that the Treasury and Treasury ministers have the lead say when it comes to matters of taxation on Scotch whisky. Other government departments look after different aspects of that industry's well-being and Treasury ministers, certainly this Chancellor, would say that they are strongly aware of the economic impact on the industry of taxation decisions that they take. It is perfectly possible that if you got these officials and, indeed, their ministers into a room, they might have different views, for example, about the level of duty which it is appropriate for Scotch whisky to bear, but it is a clear convention that Treasury ministers take the decision on that.

Q153 Mr Carmichael: Let me take that as another "no" then. The obvious interest in the DTI and the export of whisky now is going to have an impact on the price of it and its attractiveness as an export commodity. Is that something you have discussed with the DTI?

Mr Hodgson: *Prima facie* it should not significantly affect the price of exported product.

Q154 Mr Carmichael: If it is going to increase the production costs, it is going to have a knock-on cost to the sale price?

Mr Hodgson: That would have a knock-on effect on the sale price in the UK, but I cannot see why a product that is exported to other countries should be required to bear that cost.

Q155 Mr Weir: What is your assessment of price impact in the UK?

Mr Hodgson: The issue of compliance costs is something which is currently being discussed with the industry and something which I do not know if we have quite yet come to a fully agreed view, but we are getting there.

Q156 Mr Weir: We were told, if I recall correctly, by the Scotch Whisky Association that they calculate the compliance costs would lead to an increase of 40 odd pence per bottle within the UK. Do you think that is accurate?

Mr Hodgson: We find that a little bit difficult to understand. The compliance costs that the industry have identified amount to something between 10 and 20 pence a bottle, depending on how they recover the initial upfront capital costs, say 15 pence a bottle. It is not obvious to us why that should translate into a 40 pence increase by the time it reaches the shelf. If costs have gone up by 15 pence, if the final price goes up by 40 pence, somebody somewhere is making the difference in extra profit, and we find that a little bit difficult to understand.

Q157 Mr Carmichael: Can I ask you at this stage about your regulatory impact assessment. That is going to be published either before or alongside the Finance Bill, according to your own submission at

paragraph 26. First of all, to check we are all working along the same lines here, do you agree with me that the assessment of the scale of the problem is going to be crucial to the regulatory impact assessment?

Mr Hubbard: Yes.

Q158 Mr Carmichael: Because basically there is an element of costs benefit analysis in a regulatory impact assessment, so you have got to know what the scale of the problem is before you can do your regulatory impact assessment. What figures will you use as the model when you are conducting your regulatory impact assessment? Will it be your figures, the Scotch Whisky Association figures, or will it be the National Audit Office figures, if they are available by that time? They will be available. We were told they will be available before the Budget?

Mr Hubbard: That remains to be decided.

Q159 Mr Carmichael: Would you do a regulatory impact assessment, or three separate ones, on the basis of them all, or on different bases?

Mr Hubbard: This touches on the decision that ministers will have to make. Ministers have to consider what measures, if any, they want to implement. Almost by definition, certainly an explicit aspect for them to consider will be whether any such measures they take are proportionate to the problem identified. So ministers will have to take a view on the level of fraud, on what the available options for tackling that would deliver, on what the compliance costs of any such options would be and whether they were minded to introduce measures to offset those compliance costs, and, if so, roughly what those measures would be; and that judgment would obviously carry over into the regulatory impact assessment.

Q160 Mr Carmichael: Will the RIA, when it is published, make clear the model that you have followed in arriving at the conclusions that you do?

Mr Hubbard: The RIA will, in particular, need to address what the compliance costs impact of any given measures, if there are any, is and will presumably also take into account any offsetting measures which are put alongside that.

Q161 Mr Carmichael: I am sorry; I do not quite understand that. What I am asking you is, when you publish the RIA will it say whose figures you have followed in assessing the scale of the mischief to be cured? There are the three options, as I see it. Will you say, "We have followed this SWA, your own figures or the NEO figures?"

Mr Hubbard: I would expect that the RIA we can do will confirm what revenue benefit is expected from any given measure, and that revenue benefit, for example £160 million that is quoted here in respect of tax stamps is certainly linked to a given level of fraud estimation and is a proportion of that fraud.

Q162 Mr Carmichael: So when we get the RIA and it has this £160 million figure in it, we will know where it has come from?

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Mr Hubbard: Yes.

Q163 Mr Duncan: We talked about this a few minutes ago in relation to the DTI. Have you specifically discussed with them their advice in 1997 to the Norwegian Government where they strongly recommended against pursuing a similar course of action in Norway on the basis that it was inefficient and a barrier to trade?

Mr Hubbard: That letter was sent in the early part of 1997, and there is a fairly well established convention that officials do not comment in great detail on actions taken under a previous government of a different political complexion.

Q164 Mr Duncan: It is my fault. We had 18 years choose from in the last few months! Should a tax stamp be introduced are you satisfied that the UK would not find itself charged perhaps by the EU or the World Trade Organisation with introducing a barrier to trade?

Mr Hubbard: I am confident of that, and I have taken counsel's advice on that point at an earlier part in the process. Fiscal marks or tax stamps are explicitly provided for in Article 20 of Council Directive 92/12/EEC. That Directive does make clear that they do have to be introduced in a way that does not infringe the free movement of trade, and, as I said earlier, I think it is hypothetically possible to introduce a tax stamp system in such a way that it does constitute a barrier to trade, particularly were it to apply inequitably to imported and domestic product, but ministers would naturally want us to ensure that any scheme that we introduced was legal.

Q165 Mr Duncan: If there was a change of government that would preclude you from commenting. If hypothetically the Department of Trade and Industry came to you and suggested, looked for your advice in dealing with another government that was proposing to introduce a similar system, your advice would be?

Mr Hubbard: My advice on the illegality would remain the same. Forgive me, I am straining to—

Q166 Mr Duncan: Your advice on the decision as to whether it was efficient and a barrier to trade would be that it is a very efficient way of controlling fraud and it is not a barrier to trade and you would recommend the DTI went along with it?

Mr Hubbard: In the case of the tax stamp system that ministers might decide to introduce now against the background of the scale and pattern of fraud that was previously suggested to them, it would be my strong advice to the DTI that, in those circumstances, this is an efficient and effective system which will make a significant contribution to reducing fraud.

Q167 Mr Duncan: So if a major trading partner proposed the introduction of a similar scheme and the DTI recognised the effect that would potentially have on our trading relationship and came to your department for advice on whether it was something that could be challenged, your recommendation

would be that it would not and that it is something which would be a perfectly acceptable way of controlling fraud?

Mr Hubbard: I think it would depend very much on the particular nature of that other country's—the tax stamps scheme that they might introduce, how prevalent fraud was in that particular country, how capable they would be to enforce and make use of the tax stamp system. I would have no hesitation in pointing out to any other country that tax stamps has, in particular, the disadvantage of the costs that it imposes on the industry and, therefore, that any decision to introduce a tax stamp system must be a very careful one.

Q168 Mr Duncan: Do you accept that, if the UK were to go along this road, it is perfectly possible to suggest that other countries would be all the quicker to bring forward some of the suggestions under that country's system of giving you—or the DTI looking for your advice for other country's systems might be not so far into the future as we might have suggested? check

Mr Hubbard: Yes. In short I think it would be difficult, if we were prepared to put our faith in such a system for the UK, for us to be taking the line with another country with, as I say, let's assume, a similar set of circumstances. It would not be equally effective, no.

Q169 Mr Duncan: So, in conclusion, if we were to go down this road, it is all the more likely that international reciprocal action would be forthcoming?

Mr Hubbard: I think that perhaps goes a hypothesis too far. As I said, I think it would be hard for us to a country in similar circumstances to maintain that tax stamps would not be effective there. You would have to ask how many countries are, for example, part of the community of countries where there is a system which allows for movements of duty suspended spirits and where those movements are very extensive and complicated, and so on.

Q170 Mr Carmichael: On the subject of dealing with countries, I am prompted to think of the situation with regard to the wine trade. Am I right in thinking that you used to operate a different methodology in the assessment of the illicit wine trade?

Mr Hodgson: The approach we have had for estimating the wine trade has been again to try and use a gap analysis, but for both wine and for beer that methodology produces numbers which are implausible—the gap sometimes goes negative—which we think is unlikely not to not say impossible.

Q171 Mr Carmichael: So you have abandoned it presumably for the beer and wine trade?

Mr Hodgson: No, we still use information from the operational side and from surveys we have done for cross-border traffic, cross-channel traffic, but we do not have a comparable gap estimate for spirits.

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Q172 Mr Carmichael: So this gap analysis that you see as the basis of your computations is one that you cannot rely on for beer and wine and which produces essentially figures which are wildly different from the industry's own figures but which you are still prepared to rely on?

Mr Hodgson: No, I mean, the methodology, the gap methodology that we are using for spirits is exactly the same sort of methodology which is being proposed by the SWA. So there is no difference in principle.

Q173 Mr Carmichael: Exactly the same methodology?

Mr Hodgson: The methodology, the data that is being used and some of the assumptions that are being fed in, but the approach that is being adopted, which is to measure what we know about legitimate consumption to try and find some independent estimate of total consumption and the difference between the two, that basic approach, is exactly the same in our methodology of spirits and in the methodology put forward by the SWA. The only difference between us is on the data sources and some of the more detailed assumptions we have then fed into the methodology.

Q174 Mr Weir: Why should the methodology come out with such a varied result when applied to wine and beer as applied to spirits? If you are using the same sort of basis and feeding in the same sort of information, why can you get one for whisky or for spirits which is so variable with the trade figures but that you are prepared to rely on, but using the same system you come out with one for beer and spirits that you are not prepared rely on? I do not understand why there should be such a difference?

Mr Hodgson: One of the things we do when looking at the estimates, since it is a three-fold process, you start off with the methodology. You say, is this in principle a sensible methodology? You then look at some of the assumptions you are having to feed in to make that methodology to produce numbers, and you say, are these in principle supported assumptions and, in particular, is the data you are using, the survey data, is that of itself plausible? Thirdly, you look at the numbers that are produced from the methodology and say, can these be sensible, and you look at, say, operational evidence. The wine and beer estimates, in a sense, fall at the last stage in the sense that they do not produce numbers that can be plausible, therefore there must be something going wrong further up the line in the estimation.

Q175 Mr Weir: Forgive me. If the industry is saying that the figures coming out for spirits are implausible because it would mean that every single bottle sold to an independent store was a fake bottle of whisky or a non-duty paid bottle of whisky, I do not see what the difference is here. The difference seems to me that you are prepared to accept the whisky figures and the spirits figures but not the beer and wine figures.

Mr Hodgson: No, it is not the case that every single bottle of spirits sold to an independent retailer would be illicit. That statement is based upon—that statement ignores the extent of hawking, in other words, sales not through retailers. It also ignores—

Q176 Mr Carmichael: What do you mean by “hawking”?

Mr Hodgson: This is sales of spirits through car boot sales, I mean, any kind of non-retail outlet.

Q177 Mr Carmichael: What is your assumption about them?

Mr Hodgson: We have an assumption of 20%, I think.

Mr Carmichael: 20%?

Q178 Mr Weir: How on earth can you estimate something at 20% from a car boot sale?

Mr Hodgson: Not just car boot sales.

Q179 Mr Carmichael: Twenty per cent are not duty paid?

Mr Hubbard: Of illicit sales our assumption is that 80% go through wholesale environments and 20% are hawked, which is a whole range of things, not just car boot sales, but sales through—

Q180 Mr Weir: What information do you have to justify that 20% figure?

Mr Hubbard: A range of intelligence and operational sources.

Q181 Mr Weir: How many bottles of whisky is 20% of the illicit sale? It must be hundreds of thousands possibly, is it not?

Mr Hubbard: I do not have the figure off hand, but certainly a significant number.

Q182 Mr Carmichael: How many prosecutions have you had for hawked sales?

Mr Walker: Again, I do not have that figure to hand, but we do tackle hawked sales as part of our intelligence led activity. We have received a number of calls to our Customs confidential hot-line, for example, which we would follow up. We also come across it as part of our activities in the hawking of tobacco as well, the illicit sales of tobacco and so on.

Mr Weir: If you determine a fifth of all sales that evaded duty are through car boot sales or similar hawking activities, how many people do you have investigating these? Do you send people to various events? Do you keep an eye on what is going on? There must be some reliable concrete information, or is this a figure plucked out of the air.

Mr Carmichael: The States would be awash!

Q183 Mr Weir: Exactly. I do not find that credible at all.

Mr Hubbard: Assertions about the credibility or otherwise of the scale of figures we are talking about are quite difficult to counter. Two-hundred-thousand bottles of illicit spirit coming into the market every day sounds a very high figure, but it has to be seen in the context of the scale of the

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market we are dealing with, and British consumers, according to the consumption data, are buying, drinking, 1.25 million bottles of spirits every day. The Scotch whisky industry alone is exporting nearly a billion bottles of whisky every year. So just of Scotch whisky alone, 3 million bottles, let's take a rough figure, are being exported free of duty every day. When you start bandying figures of scale around, it is quite hard to put them in context.

Q184 Mr Weir: That does not answer the question of what concrete evidence you have got that this amount . . . You are saying 80% of illicit whisky is sold through retailers and 20% is sold at car boot sales, hawked around the streets, or whatever. I want to know what concrete evidence you have to justify this figure. Talking about the number bottles produced does not give any concrete evidence?

Mr Hubbard: We have to some extent talked about that earlier. We talked about the exercise in London where nearly half of shops visited had illicit spirits on display. Of course, we do not have concrete evidence in the sense of if we knew exactly where this fraud was happening then we would be handling it.

Q185 Mr Weir: Do I take from that then that you are extrapolating these figures nationwide from a relatively small sum?

Mr Hubbard: There are different sets of figures here, but the fraud estimates are based, as the memorandum explains, on gap analysis.

Q186 Mr Weir: We are talking about 80% through shops, 20% through hawking.

Mr Hubbard: Yes. That is based on an extrapolation based on our best available intelligence.

Q187 Mr Weir: You just told us it was from the exercise in Central London. Let me finish. I want to know, is it an extrapolation from a relatively small sample in a major city nationally?

Mr Hubbard: You asked me for an example of concrete evidence rather than this an assumption plucked out of the air. So I gave the London example as one piece of concrete evidence. Undoubtedly, yes, these judgments are extrapolations. They have to be because we do not have a full and accurate picture of what frauds are happening where at any one time.

Q188 Mr Weir: Is it possible for you then—I am not asking you to give it to us today—to give us a written explanation of data on which this is based and how it is extrapolated?⁶

Mr Hubbard: You mean—let me check so that I understand—you want an understanding of why we assume that 80% of fraud—

Q189 Mr Weir: And the raw data and how it is extrapolated. Where it comes from?

Mr Hubbard: In retail markets and 20% hawked?

Mr Weir: Yes.

Chairman: Maybe while you are doing that you could get for us some figures on these 40,000 a day that you are presuming are hawked. That is 40,000 crimes a day. How many prosecutions there were in, say, the last year, how many incidents there were. For example, I know that there have been raids in the Glasgow markets at the barrows, but if you were to take that figure and just multiply it round Scotland and say that this applied to every city, you would have a very false picture. It would not be an accurate assessment, because people from all over Scotland come to that particular market. So that would not expand through Scotland, but if you could get us a set of figures telling us that these 40,000 bottles a day that are presumably hawked through the UK, how many prosecutions there were, how many actual something incidents there were.⁷ Can we move on and look now at compliance?

Q190 Mr Weir: We touched upon this earlier. There seems to be a huge difference between the compliance costs that you put forward and that put forward by the industry. Can you explain why, in the first instance, there is such a huge difference and give us an idea of how you break down the compliance costs to come to your figures?

Mr Hubbard: Could I firstly say that there will not necessarily be a huge difference in assessment of compliance costs this time round. I think the comparison that the Committee was looking at last week was a comparison between information produced from a consultation two years ago and what the industry were now saying after looking more completely at their supply chain and also looking at how their costs had varied in the intervening period, the estimate the industry is now putting forward. We are still, as my colleague said, analysing the very useful information that the industry has put forward as part of its formal submission on compliance costs. I can say that it is already clear to us that the previous estimate based on the 2001 exercise is understated in terms of compliance costs and, although, as I say, we have not completed our analysis, part of the budget consideration for ministers, will be drawing on this latest information from the industry about the compliance costs that they anticipate were tax stamps introduced.

Q191 Mr Weir: I mean, the industry, for example, said that a large cost is to do with the security of the stamps themselves. Does that take into account your figures?

Mr Hubbard: Yes, I do not think we have any disagreement with the industry on the component costs, particularly at the production end of tax stamps. Security will be an issue, insurance will be an issue, machinery is an issue. We do not disagree that these costs will be incurred, and, as I say, we are examining the data that has been put forward and discussing that with the industry and will be feeding that advice to ministers. I think the one element that we are perhaps finding difficult to understand—I

⁶ See Ev 42

⁷ See Ev 42-43

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think this is perhaps also an area that came up at the discussion last week with the Scotch Whisky Association because they made clear that the compliance costs per case at the production end might be, £1 was quoted, but let's say it is £1.50 odd per case, and they also say that that translates into a retail price increase of perhaps 30 pence a bottle, or 43 pence a litre, and that is where we are finding it difficult to understand how the initial compliance costs result in an increase of that sort. There are, we think, assumptions there about profit along the distribution chain which we might want to question, but I do not think that we are likely, as I say, to stand by the compliance cost estimation work of two years ago because we now have better, more up to date, data and we will examine that carefully.

Q192 Mr Weir: Will there be any costs to Customs and Excise by the introduction of strip stamps?

Mr Hubbard: There would certainly need to be a thorough re-evaluation of the way we approach our controls to implement tax stamps effectively, and ministers have said that they will look at that as part of this year's spending review process.

Q193 Mr Weir: Have you considered the implications and costs to the Revenue of the alternative measures put forward by the industry?

Mr Hubbard: We have started to think about those. I have to say that both in terms of the compliance cost to the industry themselves of the alternative measures and of the potential resource implications to Customs, perhaps the details are less clear on both sides of that, but probably the key point there is the scale of revenue reduction that those alternative measures will deliver.

Q194 Chairman: Are you satisfied, gentlemen, that the changes to duty deferment scheme and a spirits duty freeze for the remainder of this Parliament, as promulgated in paragraph 26 of your memorandum, would compensate the industry for the compliance costs of implementing a tax stamp?

Mr Hubbard: With great respect, Madam Chairman, I think the answer to that question is probably one that is very much tied up in the Budget judgment.

Q195 Mr Carmichael: Just on that point. Would you accept that the people who are to sit here are the small players in the industry?

Mr Hubbard: Certainly that is what the compliance costs data that the industry have put forward suggests, and it is commonsense, in particular where you are making capital investment in machinery to apply stamps, that there are economies of scale there, depending on the operation you are dealing with. That is a point which ministers are explicitly concerned about, and they will be thinking about that as part of the Budget judgment.

Q196 Mr Carmichael: What sort of off-setting measures are you anticipating to compensate the industry?

Mr Hubbard: A number of off-setting measures have been discussed with the industry, including suggestions put forward by the industry about the possibility of some sort of capital assistance or something that would have the effect of capital assistance with investment. A number of ideas have been put forward, but none have yet been agreed because that would be part of the decision that ministers would have to make if they decided to take forward tax stamps.

Q197 Mr Carmichael: Are you able to find anything specifically to help the small operator in the industry?

Mr Hubbard: I am afraid I cannot really add to my previous answer.

Q198 Chairman: Thank you very much, gentleman. There are many questions that you are going to write to us on. It might well be that we decide to invite you back before we finally report on this matter, but, before we finish this session, is there anything you would wish add to in conclusion?

Mr Hubbard: No, Chairman.

Chairman: Thank you very much for your attendance.

Supplementary memorandum submitted by HM Customs and Excise

1. This supplementary memorandum provides answers to the four questions asked of HM Customs & Excise witnesses during the oral hearing on 9 March where notes were requested or offered. It also gives further detail on three other points raised. Question numbers are taken from the uncorrected transcript of the oral hearing.

IN RESPONSE TO THE QUESTION CONCERNING THE CHECKING OF LOT NUMBERS DURING THE LONDON EXERCISE

Q101 (Mr Alistair Carmichael): *"Of the 143 [locations] that you did actually seize illicit non-duty paid product from, how many of them did you check the lot numbers on?"*

2. Customs' policy is to provide details of all large freight seizures of spirits to the UK producer of the spirit, including lot numbers and sample bottles, in an attempt to identify the supply chain. However this "tracking and tracing" is generally restricted to major freight detections, in line with our policy to target the bulk supply of illicit product where likely to prove most effective. No tracking and tracing was conducted on the 143 seizures of spirits in the London exercise.

3. As we said during the oral hearing, lot numbers have only a limited use in identifying the supply chain of illicit spirits. The lot number can identify to whom the goods were originally sold, but a large production run will produce one lot number and the spirits in this production run can be sold to a number of different customers. In our experience, the producer can normally only identify each of the customers they supplied from the product run. They often find it difficult to say which customer was supplied with the particular bottles in question.

4. If a producer is able to identify a single customer for the goods in question, in the majority of cases our experience is that this company has nothing to do with the subsequent fraudulent movement.

5. Fraudulent movements often involve a long and complicated supply chain, involving multiple sales and numerous different owners. Attempts to track the product further down the supply chain are hampered by the high incidence of ‘missing traders’ (sham companies) within the supply chain.

6. Tax stamps will make illicit spirits easily identifiable throughout the supply chain. If tax stamps are introduced shop owners will know when offered non-tax stamped spirits that the products are illicit. If they choose to sell illicit spirit, associated new legislation will enable Customs to prosecute anyone found to be selling unstamped product.

IN RESPONSE TO THE QUESTION CONCERNING HOW WE BECAME AWARE OF THE FRAUD DETAILED IN EXAMPLE TWO OF THE ORIGINAL CUSTOMS MEMORANDUM

Q121 (Mr Alistair Carmichael): *“How was it detected? Are you able to say?”*

7. This case is on-going. Unfortunately we are therefore unable to comment on how Customs became aware of this fraud as any information released about the case, ahead of any prosecution, may prejudice the final outcome.

IN RESPONSE TO THE QUESTION CONCERNING THE ASSUMPTION THAT 20% OF ILLICIT SALES ARE THROUGH HAWKING AND 80% THROUGH THE RETAIL TRADE

Q188 (Mr Michael Weir): *“Can you give us a written explanation of the data on which this [assumption] is based and how it is extrapolated?”*

8. This assumption is based on the findings of an expert group of Customs officials.

9. The group found, based on operational experience and intelligence, that the vast majority of illicit spirits were sold through the licensed trade. There is little information to suggest that any more than a small proportion of illicit spirits are sold through unconventional sources, ie, “hawking”.

10. The available information was insufficient to estimate with confidence the proportion of the illicit market supplied by each route. However, in order not to over-estimate the revenue impact of tax stamps, a cautious 80:20 split was agreed.

IN RESPONSE TO THE QUESTION CONCERNING PROSECUTIONS FOR HAWKING ALCOHOL

Q189 (continued) (Mrs Irene Adams): *How many prosecutions [for hawking] were there in, say, last year and how many incidents [of hawking] were there?*

11. As stated in Customs’ original memorandum to the Committee, in 2002–03 Customs brought 21 successful prosecutions for duty evasion on spirits in the UK. In addition there were 34 successful prosecutions concerning duty evasion on mixed excise goods. From April to December 2003 there were 11 successful prosecutions for evading duty on spirit and 27 successful prosecutions for evasion of duty on mixed excise goods. Unfortunately Customs’ records do not readily distinguish what offence these prosecutions were brought for, although it is unlikely that many would be for hawking.

12. Customs’ policy is to prosecute where maximum impact can be achieved against those supplying illicit spirits—for example, the “guiding minds” behind a major criminal organisation, but also for example in respect of regular, repeat offenders and anyone selling to children. In addition to prosecution, Customs aim to disrupt spirits fraud, including most low-level illicit activity, by applying one or more of a wide range of civil sanctions including seizure of goods and vehicles, the recovery of revenue evaded, the withdrawal of approvals and/or registrations and recommending to the appropriate authority that liquor licences are not renewed.

13. Hawking of alcohol is more covert than hawking of illicit tobacco goods. This is a major reason why Customs’ work to tackle the sale of illicit cigarettes yields only a few alcohol detections. Although some hawking of alcohol is overt (eg at car boot sales), due to the bulky nature of spirits most hawking is through sales around workplaces, pubs and clubs.

14. Potential customers are shown a “shopping list” with prices and possibly a sample. Delivery is then arranged to a customer’s home or other address. This type of hawking is much more difficult to detect and Customs are reliant on the public identifying occurrences to them, for example by calls to its confidential hot line.

15. Customs resources are concentrated on preventing and detecting large-scale spirits diversion frauds as far up the supply chain as possible, before loads can be broken down and distributed into the low-level supply chains where, in the absence of tax stamps, detection becomes far more difficult and resource intensive.

ADDITIONAL DETAIL

Q102 (continued) (Mr Michael Weir): *Explanation as to why retailers are currently unlikely to know they are buying illicit spirit.*

16. Many law-abiding alcohol suppliers will be unaware that they are buying illicit spirit. Representatives from sham companies posing as legitimate suppliers will approach traders at all levels of the supply chain. The trader will normally be unaware because the spirit is offered to them at close to or at legitimate trade duty paid prices and invoices, which appear genuine, are given.

17. If this same sham company sells the product to a wholesaler further up the chain any number of retailers will end up selling illicit spirits with little chance of knowing that it is illicit.

18. If tax stamps are introduced, honest businesses in all parts of the supply chain will know that unstamped spirit offered to them is illicit. They will be able to make judgements about whether to buy it, at what price to buy it, the chances of being detected and the consequences of being detected.

Q99 (Mr Alistair Carmichael): *Strict liability—confirmation of the law relating to prosecution of persons found to be selling non-duty paid alcohol*

19. Customs have two pieces of legislation available to them when considering prosecuting shop owners for selling non-duty paid spirits: the Customs and Excise Management Act 1979 section 170 and the Alcoholic Liquor Duties Act 1979 section 17.

20. To confirm, in both Acts there is no strict liability related to prosecution. The law requires that a person must be **knowingly** selling non-duty paid goods for a prosecution to be brought against them.

Q146 (Mr Michael Weir): *Discussion concerning counterfeit product with a genuine stamps attached.*

21. It is very unlikely in Customs’ view that counterfeit spirits will have genuine UK tax stamps applied to them, even though this may have happened to a limited extent in other countries’ regimes in which genuine tax stamps may have a relatively low value.

22. Fraudsters look to maximise their profit by buying or producing spirits for the minimum amount possible and then selling it on to the legitimate market at or near to duty paid prices.

23. Customs’ operational experience is that counterfeit spirits in the UK are also non-duty paid. Paying duty would remove the largest part of fraudsters’ potential profit. Thus suppliers of counterfeit product are not expected to pay for and affix genuine UK tax stamps to their product.

24. The supply of tax stamps will be very carefully controlled. Unless genuine stamps are stolen (in which case the duty will be secured) a producer of counterfeit product is very unlikely to want to attract attention by requisitioning stamps from a legitimate source.

David Hubbard
HM Customs and Excise

31 March 2004

Tuesday 16 March 2004

Members present

Mrs Irene Adams, in the Chair

Mr Alistair Carmichael
David Hamilton
Mr John Lyons

Mr John MacDougall
Ann McKechin
Mr Michael Weir

Witnesses: **Mr Stuart Thomson**, Distillery Manager, Ardbeg Distillery, **Mr Andrew Rankin**, Production Director, Bowmore Distillery, **Mr Simon Coughlin**, Operations Director, Bruichladdich Distillery, **Mr David Barr**, Bottling Hall Manager, Bruichladdich Distillery, and **Mr Anthony Wills**, Founder, Kilchoman Distillery, examined.

Q199 Chairman: Good morning, gentlemen. First of all, could I thank you for giving up your time and coming to speak to us this morning. Before the Committee asks you their specific questions, would anyone like to make a statement or are you happy just to proceed?

Mr Rankin: We will carry on.

Q200 Chairman: I wonder if you could clarify one matter for us. Of the independent distillers—Mr Wills is not here this morning—who have we got from Bruichladdich?

Mr Coughlin: I am.

Q201 Chairman: You are not members of the Scotch Whiskey Association?

Mr Coughlin: That is right.

Q202 Chairman: Can we assume that you agree with the Association's position on the possible introduction of strip stamps?

Mr Coughlin: Yes, we do.

Q203 Chairman: How do you think that will affect your business?

Mr Coughlin: Obviously there is an industry-wide concern about the introduction of strip stamps. I would particularly like to talk about our specific business, which is obviously wholly based here on Islay now. This is for a number of reasons: we are small in terms of the industry, we are independent and we are the only company that has a bottling hall here on the island. This is a new introduction in the last 12 months, it was opened in May 2003. We are a relatively small distiller selling to approximately 25 recognised distributors around the world into 25 countries, selling relatively small quantities, although we hope those quantities will grow over the years but we are only three years old. There are three main areas that concern us. One is that in this industry the market at large is very competitive and any extra burden, either administratively or logistically, is of great concern to us. Opening a bottling hall just over a year ago was a decision made for three reasons. One was that we felt that we wanted to be in better control of our bottling programmes. Being the business had just started three years ago there was no great pattern, we did not know how our business was going to grow, and relying on third party bottlers in Glasgow or

whatever was going to be difficult for us. We felt that we wanted to take control of that situation and create our own bottling hall. Also, financially in the next two or three years it will start to become more economic to do bottling on Islay as our business grows and the fixed costs do not increase at the same rate as, hopefully, our bottling and sales do. The third reason was it would be nice to have one on Islay and be all in one place. The other side of that is we have provided 14 full-time jobs here on Islay because of it, and that is significant to an island like Islay. We see that growing as we expand. It may not be at quite the rate as our growth but it is significant. It has kept people on the island, it has helped the economy of the island, and that is in danger with the introduction of this new measure. Currently we have to attach strip stamps for three markets which is already an onerous task simply because it slows the whole process down and the fact that we will have to do this for the UK, which is our biggest market, on the one side it would mean having to employ more people but it would jeopardise the whole bottling hall concept and at the original costings it would be difficult and we would have to pass that on to our sales price. Certainly for us as Bruichladdich, although we are not competing at the sharp end on the high street, we are getting into supermarkets but it is difficult because of the costs involved in being an independent. Our margins are tiny until our business grows to a point where we are selling our own distillate. It is difficult for us.

Q204 Ann McKechin: Clearly there is no difference between the whisky industry as a whole and Customs and Excise about the fact that there is a need to tackle fraud evasion, but also there is a great deal of difference between the two sides as to how best to tackle that. Can I ask all of you what, in your view, would be the best way to combat fraud?

Mr Thomson: A good working relationship between the whisky industry and Customs and Excise, working together more. If you take the situation at the ports down in Kent, does everything get checked there? I very much doubt it. I think we could combat fraud much better by having a better, closer working relationship.

Q205 Mr Carmichael: What Customs presence do you have on Islay at the moment? Is there a Customs presence based on Islay?

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and Mr Anthony Wills

Mr Thomson: No, there is not one. That was taken away.

Mr Coughlin: None at all.

Q206 Mr Carmichael: When was that removed?

Mr Rankin: Five or six years ago. Can I just reinforce what Stuart was saying. I agree about a better working relationship with Customs but the industry already has a very, very good working relationship with Customs. As an industry, we have been working for the last year and a half directly with Customs to develop a Memorandum of Understanding and we had just got to the point of agreement on that memo when the Chancellor announced in his pre-Budget speech in December that he was going down the route of strip stamps. As an industry and Customs we have pretty well wasted about a year and a half of consultation with each other to have it literally taken away without any attempt to try and make that work. In backing Customs, I think we have a very good working relationship with Customs at present. As an industry, we all want to target fraud because these guys are penalising the legitimate traders, which—not every member of the SWA are independents—we are behind.

Q207 Ann McKechin: You are in favour of a system of licensing warehouses?

Mr Rankin: I think you are aware there are 17 points we have put forward as an alternative to the strip stamp. I do not think we want to deliberate every point today but we are keen to get something in order but just not strip stamps because of the impact it will have on our own individual businesses, as I am sure every one of us will have an opportunity to tell you.

Q208 Mr Lyons: Last week we had the National Audit Office's report on the question of spirit fraud. Clearly there is a vast difference between Customs and the industry in terms of its estimate. Do you have a view on that yourselves?

Mr Rankin: We are probably a bit biased because we have to take the SWA view. We have to be honest ourselves. We do agree that probably neither of the figures is correct because it is a difficult thing to substantiate but, as an industry, our feeling in terms of the way our goods go through the supply chain, we think that it is nearer to the SWA estimate. None of us here have been involved in the process of bringing the figures together so it is probably a bit unfair to comment, but personally I think the Customs' figures are just way off the ball park.

Q209 Mr Lyons: Does anyone else have a view?

Mr Thomson: I think if you look at the increases over a certain period of time in our estimate, the SWA estimate, and the Customs and Excise estimate, that shows an increase of around 40%. We would like to think that whisky consumption has increased by that amount over the last five or six years but obviously it has not.

Q210 Mr Weir: I presume you all make single malts. Is there any information on the type of whisky that this fraud is being perpetrated against? Is it a particular problem with malts or more the mass market blends?

Mr Rankin: I think you have to take that on a ratio basis. The blends are 90/95% of whisky consumed, so the likelihood is that 95% of duty evasion will probably be on the blended market. Simon can talk about single malts better than I. Single malts are a high value product and every company is very, very selective in who they get to distribute those products.

Q211 Mr Weir: When we talked to Customs and Excise we were interested in the lot numbers that appear on the bottles. I just wonder if Customs ever come back to any of you and say "We found this lot number in an illegal warehouse".

Mr Rankin: We had an incident about eight years ago when there was a container going to Russia and the goods were impounded by Customs. Subsequently that went through the court process. As far as I know, that is the only time in our company.

Q212 Chairman: Has anybody else had any incidents like that in living memory?

Mr Barr: What we export to Russia, and Russia now has a strip stamp in process, we export to France first and they apply the strip stamps. Strip stamps can easily be fraudulently made. I cannot see how the impact of putting a strip stamp on a piece of paper over a bottle would stop fraud in this day and age of technology, of making counterfeit strip stamps.

Q213 Chairman: Good morning, Mr Wills. Welcome to this session with the Scottish Affairs Committee.

Mr Wills: I am sorry I am late.

Q214 Chairman: That is quite all right. We know that you are not a member of the Scotch Whisky Association, but can we assume that you agree with the position that they have taken on strip stamps?

Mr Wills: My position?

Q215 Chairman: Yes.

Mr Wills: Obviously we are a fairly new company. I do not have the same distribution as the other members here. Having read through the various papers that have been presented it does appear, certainly from my perspective, that the smaller distributor or distiller is going to be hit very hard because of the additional costs that they will incur. Certainly that would be my biggest fear.

Q216 Mr Carmichael: We had a very interesting evidence session last week from various officials from Customs and Excise. If I can paraphrase what we got at the end of it, it seems that this is a problem that is created by their inability to tackle the problem of duty evasion and the solution that they seem to have found for that problem is to impose a

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regulatory burden on the production end of the industry. I see a few nods, which is encouraging. Are there any comments you could make on that?

Mr Rankin: Being directly involved on the production end from Morrison Bowmore Distillers, I will give you a little bit of information about our company without dwelling on it too much. We have our main distillery on Islay at Bowmore. We also have a distillery just outside Glasgow at Auchentoshan, which is near the Erskine Bridge, and one just outside Aberdeen. We have a main bottling, blending and vatting facility in Springburn. We are a company of some 200 people in total. Our locations are mainly in the rural areas, ie in the islands, and areas where jobs are pretty hard to come by, ie Springburn. We have just had to go through the process of laying off 25 people before Christmas because the company had been sustaining losses of over £2 million, £3 million. We are 100% owned by Suntory of Japan and obviously they have bought our company as a long-term investment but have made it clear to us that they are not prepared to sustain losses of that nature, hence the reason we had to almost re-engineer the company. We had no sooner done that than the strip stamp issue came up. For our size of company it will have a pretty serious effect. Just the cost of the equipment alone for the strip stamp is going to be over half a million pounds. That is assuming we can buy that equipment at today's price. It does not need a genius to work out that the whole industry is going to approach the one or two players who make this equipment and I think it is fair to say that these prices are going to rocket accordingly. We are not a modern facility in terms of bottling equipment, some of our equipment is 30 or 40 years old. We have very low line speeds in comparison to the Allies and Diageos of the world, so that is going to impact on a much slower line speed which will mean much less efficiency which will hit our operation even harder. We sell probably 40% of our total case business, which is only 700,000 cases, into the UK, of which a high percentage of that is in the supermarket own label area. As you are probably aware, supermarket own label sales are virtually non-profit making and are only economies of scale to get line efficiencies up, to lay down whiskies to keep the distilleries going. We cannot pass on any increase from strip stamps to the supermarket, they have just so much buying power and that is it. The net effect of that is our redressing of the losses that we carried out before Christmas will be reversed and we will be back in the same scenario. This is only a personal opinion but I do not know whether our parent company will be prepared to sustain Morrison Bowmore Distillers. We are worried about the job effects at Springburn where we employ probably 150 people, a high percentage of those in the bottling hall itself, and the other outlying distilleries and the warehouse side. From our perspective, we are very, very worried about this course of action.

Q217 Chairman: How much of the other distilleries' product would go to supermarket sales, to own brand labels?

Mr Thomson: As regards Glenmorangie, it is very much the same situation as Morrison Bowmore. It is very much economies of scale that keeps the lines going and keeps people in jobs basically.

Q218 Mr Carmichael: Can I try and place you in the market. Compared to the Diageos or whatever you are very small players, but in terms of the single malt market, where are you?

Mr Rankin: You tend to gauge the single malt markets in terms of your brands. Bowmore itself, because of the investment that Suntory has put into it, is performing particularly well. We are probably the number two Islay malt in the world and the number nine overall malt, so we are in the top ten malts in the world, but still only 120,000 cases. That is the economy of scale, that we are one of the world's top ten single malts but only producing 120,000 cases. That puts malt into perspective. The distilleries here, excluding Bruichladdich and Kilchoman, produce for single malts but a high percentage of the production capacity is reciprocated within the industry for blended products. That is where the biggest impact will be felt.

Q219 Mr Weir: The other thing that Customs indicated to us was that most of the problems seem to be after the product has left the distillery and bottling plant, in the warehousing and distribution and retailing in particular, but their solution seems to be more pressure and costs on the industry. Do you feel that you are being unfairly treated by Customs in this?

Mr Rankin: As the legitimate traders we feel that we have been penalised at the expense of the criminals. I think Customs know a lot of the companies evading duty but whether they are incapable of targeting them or they do not have the resources to target them, I do not know. In terms of legitimate traders, as you can see we are going to be crucified because of that.

Q220 Mr Weir: Simon, you mentioned your bottling plant on Islay. What additional cost is the small distillery like you going to face for putting strip stamps on bottles?

Mr Coughlin: I think at this stage it is difficult to quantify in actual numbers because I am not exactly sure what the complete implications are of the strip stamps and which bottles they will need to go on to. Certainly our basic estimates are that we would probably need to employ at least another three or four people. We will not be in a position to invest in the machinery that is required. I think it is unlikely because our bottling is semi-automatic, so it is part hand bottling and part machinery. We do not do the blends, it is just single malts, small batch bottling, very much hand-to-mouth, different strengths. All our whisky is not at the same strength. A lot of the bigger brands are at 40% volume, or 43 or maybe 46 whereas we have about eight or 10 different strengths so, again, different strip stamps for different strengths at a small bottling hall will become difficult

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to administer. In terms of the numbers, I am not sure at the moment but there will be impacts certainly in terms of employing extra people, slowing down the line, just making it less efficient to adapt to the market and the market being very competitive, even at our end of the market.

Q221 Mr Weir: You may not want to answer this, but as I understand it you will have to buy stamps to put on the bottle. How will that affect the cash flow and the viability of the small scale distillery?

Mr Coughlin: In our position—our business is only three years old—it is a long-term investment by investors and everyone else. Cash is clearly tight in a business like ours. We have done a huge refurbishment of the distillery, we have built a bottling hall for all sorts of the right reasons, and cash is very tight. Having to come up with any duty to clear stuff for the UK is an issue even on deferment, and I understand that there may be some deferment brought in in regard to strip stamps, but how that will work we do not know, I do not know that any detail has been published on those, but it would be very significant.

Q222 Mr Carmichael: You are talking about different strengths of whisky. Presumably that involves different amounts of duty payable?

Mr Coughlin: Yes.

Q223 Mr Carmichael: Which would then mean that you would have a different strip stamp for every bottling?

Mr Coughlin: Correct.

Q224 Mr Carmichael: Presumably this in itself is going to be an extra cost. You mentioned you have 14 people employed. Is that just in your bottling operation?

Mr Coughlin: Yes, just in the bottling. We now have 29 people employed full-time at the distillery, which means that we are the biggest employer on the island.

Q225 Chairman: That is clearly going to be very significant for the economy of the island?

Mr Coughlin: It has actually. For the whole island, but particularly the Rhinns, which is our side of the island, it is rejuvenated. There are a number of people working for us now who were very close to leaving the island with their young families who are now employed full-time and will stay there for their working lives. We have been very successful with the New Deal training scheme. We have had over 20 youngsters through that scheme and to about 12 of those we have offered full-time jobs. We have a mixture of experienced distilling staff who were laid off in 1994 when the distillery was last closed by its previous owner, and only two were retained, we have re-employed all those distilling staff who have the experience and we have supplemented that with youngsters and given them a trade. Only last week, the very first trainee cooper in Scotland for I do not know how many years—

Mr Barr: Sixty-four.

Mr Coughlin:—sixty-four years has started at the distillery. The viability of the bottling hall being put into question does impact on the rest of the business. We should not just look at the bottling hall and say “Okay, the bottling hall does not work, we can get it done cheaper in Glasgow”, no, because their prices will go up as well. We will be squeezed at the tight end of the market. We do not have the budgets to offer the discounts to get into the places, we have to get there by the quality of our product but it is still price sensitive. We are growing slowly each year and it is going okay, but anything that might take it the opposite way concerns me greatly and my fellow colleagues, as it does the staff.

Mr Rankin: On that question, the resultant increase in businesses in terms of small to medium, the volumes increase quite substantially and with that duty deferment being taken away from us the actual cash out per month increases tremendously. Taking it up even to a company like Whyte & Mackay who employ some maybe 1,800 people it is a pretty catastrophic cash outlay on that duty deferment being taken away. It certainly is for us. I have just calculated very quickly that our borrowings would need to increase by circa £2 million just by that abolition of deferment. We are already heavily borrowed and our parent company have informed us that there is no more money to increase debts. That is a real bad one for us.

Mr Barr: Could I address the question that Mr Carmichael asked about the different strip stamps. As a company, Bruichladdich, we put strips on different strengths and the main market is 40%, 43%, possibly 46, but we do 42.4, large amounts of different strip stamps. You cannot address the strength until you vat it, so you have to have a collection of casks that you will then vat and at that point you get the strength so there is a delay in the bottling. Once you establish what your strength is you have to then apply your strip stamps that might not even be produced. The mass production will probably be 40, 43 or 46, they might not have 42.4 or 44, so there is a delay and for us to meet the customer demands, being on an island, is tight as it is. We have to wait for these strip stamps to be made and purchased and by that time our customer might have gone elsewhere.

Q226 Mr Lyons: On the strip stamp itself, have any estimates been made of what it will cost in terms of each individual company if you have got to lay out money, apart from the point you made earlier about the outlay for the stamps? What will the overall cost be like?

Mr Rankin: Per company?

Q227 Mr Lyons: Yes.

Mr Rankin: The biggest cost is the abolition of the duty deferment, that is your real upfront cost where your cash flow is impacted straight away by that one month deferment being taken away. Every company is going to have an incremental cost. In terms of the logistics of buying and monitoring strip stamps, and

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I am assuming you will be familiar with the strip stamp itself which is a tiny, thin little bit of paper, it comes in huge blocks but every single one of them is worth £5.50.

Q228 Mr Lyons: It is that angle that I am interested in, the security costs.

Mr Rankin: I was just leading on to that. For the likes of our company, we will have to purchase some £2 million worth of those on a monthly basis. We are going to have to build secure areas. We are going to have to employ people to monitor them to keep them secure and people on the line to administer that side of it. As you know, a bottle does not start at A and finish at B, you have breakages, you have mislabelled bottles, but every single one of them will have a strip stamp that has to be accounted for. For our size of company, and everybody is the same to a certain extent, it is additional manpower that basically we cannot afford just now and it is operational inefficiency and security. I do not need to tell anybody here that Springburn possibly is not the safest of areas and if people know that there is £2 million worth of stamps sitting there, which is just as good as cash, you can bet they are going to go out of their way to try and get that. We are genuinely worried about the security of holding two, maybe more, million pounds' worth.

Q229 Mr Lyons: Have you looked at it in terms of the insurance related to the security of strip stamps?

Mr Rankin: They are all going to back off. Our company secretary is looking into those. Yes, I think it is fair to say that our insurance premiums will rise accordingly. Just now with the duty deferment it is a bank transfer, there is no physical cash, but now you have got something that is as good as physical cash so I think it is fair to say our insurance will increase, as everybody's will. The larger the company, the bigger the insurance will be because you are into multi-site security, etc.

Q230 Ann McKechin: Customs and Excise have claimed that if strip stamps were introduced they could reduce about 27% of fraud overall. The Scotch Whisky Association in their proposals, which Andrew Rankin mentioned as part of the Memorandum¹, claims that if they were implemented they could prevent about 50% of the fraud. Do you agree with the Scotch Whisky Association's alternatives which they claim would deliver more benefits and deliver them quicker than a tax stamp?

Mr Rankin: There have been 17 different proposals since December of last year when this was announced in the pre-Budget speech. Every single company, the senior people in the company, have spent an inordinate amount of time on this subject which shows how this industry is against the strip stamp. These 17 proposals all have merit individually. We are not as close to it as the Scotch Whisky Association in terms of direct dealings, but

within the 17 proposals there will be ones that individual companies would prefer over others. I think it is fair to say that each of the proposals will work towards reducing fraud without the burden that would be put on us of strip stamps.

Q231 Ann McKechin: So you would prefer that the Memorandum proposals be implemented for a period of time to see what results come out of it before they agree?

Mr Rankin: Yes. The Government, Customs and Excise and the industry should have given that a chance to see what effect that would have. Certainly within the 17 proposals, and I cannot remember them offhand to be honest, there are some proposals that are beneficial with very low cost impact. I think we should give the Memorandum of Understanding a try and then look at the 17 proposals and work with Customs, which we do as an industry, and decide collectively what the best one to choose is that will have least effect on resources to Customs and resources to the whisky industry. I do not think the industry is against identification of some sort on the bottles but, as we were talking about earlier on, it could be as simple as a form of—I will not call it strip stamp—identification on the back label that is making the statement that it is UK Duty Paid, almost like a packet of cigarettes. That would also give the impact that the Government wants but it does not affect our operational ability or the deferment of duty or having to secure strip stamps that are as good as cash. That was a long-winded answer.

Mr Thomson: I think the proposals of the SWA deserve a chance. I do not think it is any coincidence that the biggest market in the world, which is the USA, has found that strip stamps do not work and has removed them from the system.

Mr Rankin: There is a very good article about the Mexican Government who have just announced the abolition of strip stamps. They are targeting the crooks rather than imposing a burden on the producers.

Q232 David Hamilton: Following on from that, what is your view on the possibility of counterfeiting the tax stamps?

Mr Rankin: I had a meeting with a chap called Andrew Samuels who works with the printers, Gavin Watson. They do a lot of printing for the government. He put on a very good presentation to our company and I know he has been speaking to other companies in the industry. He has gone through a basic strip stamp, which is the easiest thing in the world to counterfeit, and a hologram strip stamp, on which there is some control but you can go to China and buy a hologram off the peg. Each measure that the government has put forward he has a countermeasure for. Basically what he is saying is, "If I have a countermeasure you can bet the crooks have a countermeasure" and, in his words, "these are the easiest things in the world to counterfeit".

¹ See Q206.

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Q233 David Hamilton: Following on from that, do you think that the same thing will happen in the UK as happened in Ukraine earlier this year? I understand that they started strip stamps and within three weeks 66,000 bottles of illicit alcohol was found.

Mr Rankin: I think it will happen. It is difficult to detect a bottle of whisky just now that is counterfeit in terms of whether it has evaded duty just by looking at it. It is not going to be any easier to detect whether it has got a strip stamp or not. If we go down the route of strip stamps you can only detect it by saying, "There is a bottle with a strip stamp, there is one without, that has not paid duty. There is a bottle with, there is a counterfeit with". It is impossible.

Mr Thomson: If you can forge the main label on a bottle I am pretty sure you can produce the counterfeit strips.

David Hamilton: If the value is high enough it is worth a go.

Q234 Mr Weir: The Scotch Whisky Association also suggested that there was a danger of counterfeiters using genuine tax stamps in order to disguise counterfeit whisky as the genuine article. They quoted instances in the Philippines where real Spanish strip stamps had been affixed to counterfeit spirits. Do you see that as a problem and will it make things worse rather than dealing with the problem?

Mr Rankin: I think it will. If you look at worldwide currency, it is counterfeited. It is in the system and it is doing the damage generally before it is detected. The only way it is detected is by banks, etc, with sophisticated detection equipment. The counterfeiters are getting more professional in their ability. Certainly they can do anything, jewellery, money, and a strip stamp is not a difficult thing to counterfeit.

Q235 Mr Weir: What they are saying is that you may have a fake bottle of your brand with a genuine strip stamp over it. Do you see that as being a potential problem?

Mr Rankin: It always has been a problem. Do you mean the product within the bottle?

Q236 Mr Weir: Yes, that has been counterfeited.

Mr Rankin: That always has been, and always will be, a problem. It is like any counterfeiting now, you have to keep challenging, checking, basically trying to sicken the counterfeiter but these guys are pretty strong. In terms of the overall fraud that would be a smaller percentage than just counterfeiting the strip stamp itself.

Q237 Mr MacDougall: I did want to ask you about the instances of counterfeiting but you have already said you believe there would be an increase. Could I take you on to the Scotch Whisky Association again and some of the comments they have made. You have already touched on this as regards the direct and indirect employment potential for the future. I think you said that the strip stamp business would put your emphasis on to the administrative side of

the business rather than the growth side, production etc., and therefore, of course, you would get an increase in employment immediately but that may result in cash flow and profits being cut back eventually because you have not matched it with production increases. At the end of the day, have you any idea how long that shift would take to affect the employment levels? How much do you see that being a threat to you in terms of the employment potential for the future?

Mr Rankin: That would assume that you could afford to employ them in the first place. Simon has mentioned the risk to his bottling hall. I have to say that if this goes through tomorrow we would have to have a serious look at whether we could afford to keep our bottling operation going. Your question may be completely irrelevant, we may not be able to afford to employ anybody because we will be physically looking at putting our bottling outside or withdrawing from that segment of the market, which probably would be more likely.

Q238 Mr MacDougall: You think the impact would be almost immediate? Could you measure that?

Mr Rankin: It will not be for big companies. Strip stamps is merely an inconvenience to the Allies and the Diageos of the world, it is the medium to small companies that will take the impact. Forty per cent of our bottling is for the UK trade, of which a high percentage is supermarkets. On some of those we are already losing money, we are not recovering overheads, and any increase to that is unsustainable. It is not just firing blank shots, I would think we are running a serious risk of losing our bottling facility in Springburn.

Q239 Mr MacDougall: The point you made earlier was about the impact on an island like Islay where the biggest employment has been on the bottling side of things.

Mr Rankin: The impact in terms of how that would affect Islay is it would not affect Islay in terms of producing for the single malt but at Bowmore we have already cut back on production by 30% because we cannot afford to lay down whiskies for supermarket own label blends in three years' time, it is an unsustainable investment unfortunately. Whereas Simon is employing on the island with his bottling hall project, we have had to reduce our numbers. Any reduction on supermarket business would have a further effect not only on Islay but on the facility at Auchentoshan and the distillery up north that is already running at an uneconomical level.

Q240 Mr Carmichael: Just following on from that, there is an interesting spread here. Stuart, it is not that many years since Ardbeg came back and you have got Glenmorangie behind you, three years for Bruichladdich and, Mr Wills, you are looking to set up a micro distillery. If you were all at that stage of anticipating coming back into or entering the market in the circumstances in which you operate,

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what impact would the introduction of the strip stamp, and in particular the loss of deferment as a result, have on the decision that you made?

Mr Coughlin: It would not have happened, as simple as that.

Q241 Chairman: No doubt about that?

Mr Coughlin: No doubt about it. It was difficult enough as it was.

Q242 Mr Carmichael: That is 29 jobs.

Mr Wills: I am not sure that would be the same for me because, again, we are going to be a far smaller operator than the other seven distilleries on Islay. Yes, it would have an impact on the amount of cash I would have had to raise, and I would have had to raise significantly more cash than I have already, and that has taken long enough as it is. Yes, it would impact but it would not prevent me from going ahead.

Q243 Chairman: Is that just determination?

Mr Wills: I have been three years at it.

Mr Thomson: If you want to be perfectly honest and frank about it, I came to this island seven years ago and I looked at Ardbeg Distillery and Bruichladdich Distillery and if strip stamps had been introduced seven years ago, or three years ago, both distilleries would never produce again because of the impact of the strip stamp. We have been lucky at Ardbeg because Glenmorangie has invested very heavily. I know some of you have been there and you will know it has, to coin a phrase, come back from the dead. With the introduction of strip stamps the knock-on effect would be that there would be more investment through capital expenditure and more people employed at Broxburn, which is our bottling hall. Ardbeg is thriving at the moment but one can only assume that because of the cost the company would invest less heavily in the thriving community which is Ardbeg.

Mr Rankin: There is the perception of the whisky industry that every member company has lots of money and do not know what to do with their money, but nothing could be further from the truth. There are big companies making massive profits but making massive investment as well in terms of jobs. The single malts will survive but they may survive on a much smaller scale and do not have a bottling hall, etc. It is the blended segment that it is going to hit hard. I will mention supermarket own label just as an example. A case of 12 bottles without duty in the early 1990s sold for £16 a case to a supermarket but that price today is now as low as £5.50. If you take inflation in terms of the raw product and packaging but take a third of your price, the economy of scale is just not there. That is why people who are primarily in the blended market are going to suffer more than anyone else will suffer. That £5.50 will not even rise to £5.60; the supermarkets just will not allow it.

Q244 David Hamilton: It sounds similar to farmers with big supermarkets, their buying power is so strong. I did not realise it was as big as that. Andrew, you indicated about the Springburn bottling plant and some of the evidence we have received is that where you have a bottling plant it does more than just whisky, there is the possibility of some of the bottles being moved abroad and that would create a higher cost per bottle going through. Is your bottling plant in that similar position?

Mr Rankin: No, we do not have any—

Q245 David Hamilton: It is just pure whisky?

Mr Rankin: Pure whisky, yes.

David Hamilton: That is just another side of the issue, Chairman.

Q246 Chairman: Can we look at compliance costs to the producers and the consumers. There seemed to be a wide variation between Customs and the industry's estimates in the compliance costs, although last week when we did have Customs and Excise before us they did seem to acknowledge that their estimates were some two years old and, therefore, obsolete. How much do you think the compliance costs will be for your company, just a rough estimate?

Mr Coughlin: It is difficult to put a number on it at this stage, to be honest. Certainly the cash flow implication is so significant. I have just done some basic figures on what we supply into the UK and it would be back cap in hand to our shareholders to see if they will support it. It will affect us significantly because I do not think the banks would be too happy about it. That is just purely the cash flow in terms of duty deferment but there is obviously employment, security, administration and all the other bits and pieces. Yes, it will be significant. Our business is just at a point where we hope to break even in 2004 after three years but that whole thing will be put back I do not know how many years and it is a question of whether it can be stomached by ourselves, the shareholders and everyone else. It will be a significant impact.

Mr Barr: If I could add a point about the application of strip stamps. Morrison Bowmore has got how many machines?

Mr Rankin: Three main ones and one auxiliary one, four machines.

Mr Barr: We have two lines, one a semi-automatic and one a line for miniatures. A miniature case has 96 bottles in it and to hand bottle that, to do ten cases would take three people a full day but to apply strip stamps it would take almost a week. They are sold in the UK market so they would have to be applied. I have seen one at Morrison Bowmore, they had one machine and it was not very successful and they reverted back. I know of one machine that does all the sizes but we would have to purchase other machines for smaller ones.

Mr Rankin: Yes.

Mr Barr: Then we are not just talking of three machines for each line, we are talking of multiple machines.

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Q247 Chairman: Presumably different bottle shapes need different applications?

Mr Barr: Yes.

Q248 Chairman: I have got Chivas in my constituency and I know they are concerned about just the process of applying the stamps. They say even with a machine, given that you have paid £5.50 or whatever for each stamp, sometimes the machine will apply four or five stamps at a time to one bottle so, therefore, you have got £30 on that one bottle.

Mr Rankin: That is where the implications come in relation to security. It does not sound very much but Chivas, I think, have bottling line speeds of something like 500 bottles a minute now and that is a phenomenal speed and a person cannot just say "There are four strip stamps on that", so you have to have a start process, an end process and somebody counting them, but I do not know how you count them because they are so thin. That is a serious implication on a fast moving line but as it goes down the implication is the same. Our fastest line speed is 200 and that is on the best of best days, which are few and far between, but we have the same problem. Just on equipment, we have three lines, one automatic line and two semi-automatic, but the capital cost of the equipment is just on £500,000. That is at today's purchase rate but we know, as an industry, if this gets nodded through tomorrow that price is going to rocket. That is just the capital equipment. If we have to put that on each of our bottling lines, our bottling hall is very, very small, it is very tight, and we do not think we have physically got the space to put strip stamp machines in. That is why we are pretty vociferous in fighting against this. The likelihood is that if this goes through we will probably close our bottling hall.

Q249 Mr Weir: Could you clarify the point about miniatures. Are you expecting to put strip stamps on miniatures as well as full bottles? I understood when this was first proposed two years ago that miniatures would be exempt from the strip stamp.

Mr Barr: If they are exempt then there would be a range of other sizes as well and what size is this exemption at? If it is exempt now, later on does it come into play? Is it a foot in the door?

Q250 Mr Lyons: When the SWA came before the Committee we asked them to estimate what the changes would mean to a bottle on the shelf and their view was 40-50 pence per bottle. Do you agree or disagree with that?

Mr Rankin: I think every company has a different figure. Obviously the bigger companies have much more efficient equipment so their unit cost becomes lower. For Simon and David, I am sure their unit costs will be much, much higher. We are probably sitting in the middle. I am just looking at something our accountants have prepared and they are looking at 30 pence a bottle, roughly £3 a case. It is unsubstantiated at the moment because we do not know physically at what speeds the lines would operate. We are making a guess and the efficiencies

are the biggest impact on that cost. Also there is the duty deferment question: is it going to be taken away or is it going to remain? It is a difficult one. I do not think you are out of the ballpark with that.

Mr Thomson: Whisky must retain its competitive edge. This is a personal opinion but maybe because of the competitiveness the price of a bottle might fall back into line, although obviously the knock-on effect of that is that our profits are interfered with.

Q251 Mr Weir: How do you feel that the increase in a bottle of whisky would affect your export market? As a side issue, perhaps being devil's advocate, how price sensitive is a bottle of single malt as opposed to a bottle of blended whisky?

Mr Rankin: Simon is at the sharp end, I am at the production end. The whole whisky market now, whether it be cheap blend, mid-range blend, entry malt or premium malt is very price sensitive. On the malt which is maybe commanding £30 a bottle for a standard type malt, a one or two pound increase on that would have serious effects on consumer buying. Worldwide, as you know, consumers are being more careful with their cash and if they see a brand rising without any logical reason they are going to trade down to either another competitor or a lower quality product. The malts are the one segment in the market just now that are performing well in terms of price but we are all in the Islay category and we are all competing against each other and it only takes one to break and that segment of the market comes tumbling down, margins get eroded and we are in the same scenario as the blended segment of the industry where £16 a case tumbles to £5 a case and it becomes an unsustainable industry. My personal opinion here is that we are talking about capital expenditure, the duty deferment being taken away, but I think the biggest impact—this has not been mooted terribly much, I am sorry to say—is on the job front. Certainly it will not affect the big companies because it is an inconvenience for them but for the medium to small sized companies it will have a serious impact.

Q252 Chairman: And there will be an impact on a fragile community like Islay.

Mr Rankin: Not just the industry, it is the suppliers to the industry, the glass industry, the packaging industry, the transport industry, they are all going to suffer as a result of this.

Q253 Mr Weir: How would it affect any plans you might have for expansion of the business? Could they go ahead?

Mr Rankin: No. Personally we will be going the other way, we will have to cut the cloth. At the end of 2003 we ran up a £3.3 million loss on £30 million turnover, which is completely unsustainable, and our parent company will not give us any more money. Our borrowings are up at £28 million. Many a company would be classed as bankrupt with that sort of financial performance but, fortunately, Suntory are a big company but they are not going to keep ploughing money into a company performing like that. To add another one million of costs by the

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time you take into account capital expenditure, duty deferment, etc, just becomes completely unsustainable. We are worried as a company.

Q254 Mr MacDougall: I take the point you are making about the larger companies but would you not agree that for the larger companies it is much easier for somebody to give the impression that products like vodka and gin, the product itself, could be easily disguised, it is not as distinctive as, say, a Lagavulin or something like that which once you open it up and taste it you will notice much more easily. Is it not easier to catch the fraudsters in those types of products than it would be in the vodkas and gins? I think in the larger companies it is important to take into account that the impact might be retrospectively just as hard.

Mr Rankin: I am probably doing the big companies a disservice. Their profits are huge but they have the same cost base, they just have different economies of scale. We tend to be talking here about Scotch whisky but you have all other spirits that will be impacted in the same way.

Q255 Mr MacDougall: I think it is important that we make the point that the whole industry in some way is going to be affected by stamps.

Mr Rankin: It does not affect us here because we are not multi-product but Whyte & Mackay, who employ a couple of thousand of people, are gin and vodka, they have a grain distillery, so you are correct in that.

Q256 Chairman: Do you consider that any changes to the duty deferment scheme and a spirits duty freeze for the remainder of this Parliament, which was promulgated by Customs in their memorandum, would compensate the industry for the compliance costs of implementing a tax stamp?

Mr Rankin: Certainly duty deferment would be welcome because that has a big impact on the monthly cash flow. I am sure the industry would welcome the spirits freeze but the rest of the problem would remain the same, namely capital investment.

Q257 Mr Carmichael: I think we are quite close to the end. Can I just have a brief canter on one of my favourite hobbyhorses. You mentioned earlier that there is no longer a Customs presence on Islay. For many years there were certainly at least two full-time Customs employees based here. Probably the relevance of this is the question I asked you earlier about the difficulties that Customs and Excise have of policing and then putting the burden on to the industry. Does the absence of a Customs officer on Islay have an impact on the way that you do your business? What is the presence on the island, do they not come near you at all on the production side?

Mr Thomson: They will come in and basically audit us from time to time.

Q258 Mr Carmichael: How often do you see them?

Mr Thomson: I would see them about once a year.

Mr Coughlin: We have had two visits.

Mr Rankin: At Springburn we have got them on an almost weekly basis. We are almost used as a training school for Customs and Excise at the moment. We are happy to help. We have had Polish, Estonian, goodness knows what Customs. I have to say that, yes, there is a job to do but they know we are legitimate traders, why spend an inordinate amount of time in there, they could be at the sharp end where the fraud is being committed and targeting these guys. In a year auditing our place they might find a couple of hundred litres of alcohol disappear through additional losses, and that is spillage, etc., and the duty on that is a few thousand pounds. It is at the other end where you get the hundreds of thousands that you want to target.

Mr Coughlin: I think this really is the nub of the problem that you touched on earlier and again here, that there has been this contraction within the offices of Customs and Excise, or generally amongst Customs and Excise. We all have very good relationships with the people that we work with, but we would because we do not have a problem, there is not an issue. They do not have an issue with us, it is down the line. Either because Customs and Excise do not have the resources or there is not the will to invest in Customs and Excise in the policing of the problem down the line, it is being thrown right back at the distillers who do not really have an issue with Customs and Excise. They think, "They can cope with it, they are big companies with huge profits" and that is why I am delighted that we are here today because we are not part of that group. We are the medium to small group who simply cannot afford this measure.

Q259 Ann McKechnin: For you a once a year inspection, audit, is all you think Customs and Excise need to do?

Mr Coughlin: Yes, it is self-regulatory now basically. As long as you keep your nose clean and you are doing it right, we have a good relationship with them. There is not a problem at all.

Q260 Mr Carmichael: What was it that Bill Murray used to do that is no longer done?

Mr Coughlin: You were not allowed to go in or out of a Customs warehouse without a Customs officer there, it really was to police and, I suppose, going back many years, theft out of distilleries and bits and pieces like that, but it was tiny, spillages. In relation to the overall issue that we are discussing of fraud, it was just miniscule.

Mr Thomson: At the end of the day we do not run our distilleries any differently now than we did 12 years ago when a Customs and Excise officer was here all the time.

Mr Barr: We still work a two key system, accepted procedures, there is full traceability of spirit, of distillate. You operate a system where you can trace it all the way back.

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Mr Rankin: Yes. The problem is not with the legitimate trader because we have probably got the best practices in the world in terms of keeping an eye on spirits in the warehouse, it is when it leaves and hits the end of the chain that you get the fraudsters.

Q261 Ann McKechin: If there were prosecutions by Customs and Excise then proving the chain from your side to the warehouse should not be a problem at all?

Mr Rankin: Yes, it is all computerised. You can press a button and you have got the complete chain of events from the day it was filled to the removal from the warehouse to the bottle it went into, the case it went into, to the customer it went to.

Q262 Ann McKechin: The nub is that it is controlled from the warehouse.

Mr Rankin: It is getting further down the supply chain. As an industry—this sounds as if we are having a pop at Customs—many years ago we offered ex-industry employees either as consultants or employed by Customs, people who had been in the industry for 20–25 years, who knew the supply chain inside out, to assist Customs in targeting this and it was turned down. They would go and employ somebody who had no experience of whisky or spirits as an auditor rather than employ somebody who has been in the trade for years. I think there are a lot of lessons that Customs, given the resources which have to come from the Government, should take on board.

Q263 Ann McKechin: It is not just the quantity of staff, it is the quality.

Mr Rankin: It is the quality as well, yes.

Q264 Mr Lyons: Just on the quantity of staff, for the record—

Mr Rankin: I hope there are no ex-officers here.

Q265 Mr Lyons: At Dover alone they have taken over 1,000 people on in the past 15 months, so if they come with a tale of “We are not getting the resources”, chase them because they are getting the numbers and the service is expanding all of the time just now.

Mr Thomson: It is different from the drug industry because in the drug industry they want to get at the source but in the whisky industry rather than getting at the source they want to get the pusher.

Q266 Chairman: Before we finish the evidence session, gentlemen, we have exhausted our set questions to you but if there is anything you want to add to that, or perhaps areas that you think we have not touched on, please feel free to do so.

Mr Rankin: I would only add an appeal, although I do not know whether it is too late because the Budget is tomorrow, that whatever help you can give the industry to either reverse or stop this would be much appreciated. I have been in the industry nearly 30 years now and this is probably the most serious thing I can think of in terms of future prospects, mainly with regard to jobs.

Q267 Chairman: As you probably know, we are just half way through our inquiry but, as an interim measure, last week we sent a note to the Treasury to urge great caution in this because just from the evidence we have taken we are very far from convinced at this point that that is the way to go.

Mr Rankin: We had John Healey down at our distillery at the end of February and we thought that would be an opportunity to get the message over firmly, but whilst he listened he did not give us any positive encouragement that this looked as if it could be reversed, it was the opposite view he took, that this was a *fait accompli*. Your help would be much appreciated. That is all I would say.

Q268 Chairman: Can I thank you very much indeed for your evidence this morning. Can I assure you that this will be of great help to us when we come to making our final report, copies of which will be sent to you.

Mr Rankin: Thank you all for listening.

Thursday 1 April 2004

Members present

Mrs Irene Adams, in the Chair

Mr Alistair Carmichael
David Hamilton
Mr John Lyons
Mr John MacDougall

Ann McKeichin
John Robertson
Mr Michael Weir

Witnesses: **Mr Andy Colvin**, Supply Chain Manager, Beer Wine and Spirits, Sainsbury, **Mr Chris Lonergan**, Manager, Customs and Excise Solutions Team, Price Waterhouse Cooper, **Mr Howard Winn**, Product Quality Manager, Beer Wine and Spirits, Sainsbury and **Mr Quentin Rappoport**, Director, Wine and Spirit Association (WSA), examined.

Q269 Chairman: Good afternoon, gentlemen. May I thank you very much for your attendance this afternoon. Hopefully we shall not detain you too long today. Before the Committee turns to specific questions, do you have anything you wish to say as an opening remark?

Mr Rappoport: May I just introduce us? Thank you very much for asking us to speak. Firstly, may I introduce myself? I am Quentin Rappoport, I am the Director of the Wine and Spirit Association. We represent importers of spirits into the UK and also distributors and retailers through to the consumer, including supermarkets. The UK market for spirits is split roughly three ways. You have Scotch whisky as one third, home produced gin and vodka as one third and imports one third. That is very rough, but it is the last one which is our side of things. Before I go any further, may I introduce our team? We have Andy Colvin and Howard Winn who are from Sainsbury's and they can speak on the sort of security and tracking systems which apply in large retailers. Chris Lonergan at the other end is from Price Waterhouse Coopers and incidentally ex Customs and Excise, which may be relevant. He has worked on the industry alternative to strip stamps which we put together.¹ We had hoped to have a representative from Tesco's as well to give the balance to Sainsbury's, but unfortunately there was a crisis at the last moment and our man was not able to come. I am assured that the sort of procedures which apply in Sainsbury's also apply in Tesco's, so Sainsbury's should answer your questions. Briefly, there are three spirit associations, Scotch Whisky, Gin and Vodka and Wine and Spirit Associations. We have worked very closely together on the question of strip stamps because we all have concerns that the proposal which has been put forward will impose unnecessarily heavy costs on the legitimate trade without providing an effective counter to fraud. Firstly, I must say that we are all obviously against fraud and we want to stop it, but we believe that the government has given a far higher estimate of the amount of fraud around. They say £600 million a year and rising, whereas industry has estimated that it is £150 million and falling. The savings from strip stamps, which they have estimated to be about one quarter of the total, would

come to about £40 million at most a year, whereas we have measured the cost to the trade as being £54 million. That is the first thing: we feel it is out of proportion. The second thing is that if you accept—and we shall give you a chance to quiz the supermarkets to show this—that they have such systems that no fraud could happen in the chain to them, they are 70% of the off trade. If you then say that there are similar considerations with the big major off-licence chains and the big pub chains, then really there is very little left to allow for the government estimate of one bottle in six being subject to fraud, because an awful lot of it goes through very, very simple procedures. Thirdly, the strip stamp scheme itself is prone to forgery and theft. There is a huge incentive to forgery with them being worth about £5 each. It has been shown in other countries that forgery does happen. Because of that, any benefit which you can gain against the fraudsters will lessen over time as people find ways to imitate the product, steal it or whatever, whereas the cost to the legitimate trade will carry on year after year. Finally, the industry believes, and this is all three of us, that we have more effective ways of tackling fraud which will be more efficient, will last for longer without ways being found round it and will come into force earlier. We can talk about that in more detail. That was just an opening scene-setting statement. Thank you very much.

Q270 Chairman: Would it be safe for us to assume that the entire spirit industry considers these proposals to be flawed?

Mr Rappoport: Yes.

Q271 Mr Weir: You have accepted that everybody is against fraud in the spirits industry, but we have heard conflicting evidence about where fraud might occur. Can you tell us what your views are as to where there is scope and where fraud occurs? Is it in production, distribution, retail? Where would you see fraud within the system?

Mr Rappoport: We could answer that first of all by looking at the retail end, because I think you are going to say it is not there.

Mr Colvin: With the retail supply chain, certainly from the supermarket point of view, we have full traceability throughout our supply chain, through the systems we have. All the orders which are placed

¹ Not published.

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have distinct order numbers and all of the deliveries which move from one point to the next are all sealed deliveries. When it leaves either the bonded warehouse or the supplier, if it does not come with the same seal number to the regional distribution centre as is on the documentation which left the supplier, we will not unload that vehicle. We have records of both how much product we are getting, from whom we are buying it and that is all easily accessible for Customs and they do view that when and if required.

Q272 Mr Weir: Do you have a dedicated supply chain or do you get from a distributor who distributes to other parts of the trade as well?

Mr Colvin: There are two parts to our supply chain. The majority of product in spirits is bought through the major suppliers such as Diageo, Allied Domecq, Maxxium. That is all duty paid. At the point we take control of it as a supermarket the duty has already been paid. There is a small proportion, 5 to 7% of our product, which we actually put through our own bonded warehouse, for which we are the official warehouse keeper. The suppliers who use that bonded warehouse actually use our deferment account. In effect we take responsibility for the duty on that product and they will use our deferment account, so Customs are happy with the robustness of that. It is quite a simple supply chain. If we take it direct from a supplier such as Diageo, it goes straight from Diageo to one of our regional distribution centres, of which there are up to 12 and then goes straight from there to the store. If we are taking it in bonded, which is about 7% of our volume, we will take it direct from the supplier to a bonded warehouse, where we store it and then move it out from the bonded warehouse to the regional distribution centres. From there it goes to a store. There are two chains: one has two links in the chain and the other has three, where we include the bonded warehouse.

Q273 Mr Weir: Just for clarity, when you say you take it into your own bonded warehouse, would that be supplies from small suppliers rather than from the likes of Diageo?

Mr Colvin: Yes, it is.

Mr Winn: There are two aspects there. For our standard things like Scotch whisky, vodka and gin, which we sell under the Sainsbury's label, we purchase these products from reasonably large suppliers. Obviously, for our premium whiskies such as our special malts, these are single malt products and those will come from much smaller individual producers.

Q274 John Robertson: Mr Weir was asking where you think most fraud occurs. You did not really answer that, not to my satisfaction anyway. Apart from that, do you have absolutely no fraud whatsoever? Do you not lose any of your spirits whatsoever from your bonded warehouses or from your stores?

Mr Winn: It would not be sensible to say we do not lose any spirits. Obviously a certain amount will be damaged in transit but it is a miniscule proportion. It is in our vested interest to avoid any loss, because it is a financial loss.

Q275 John Robertson: Could you tell me exactly how much has gone missing?

Mr Winn: I cannot give you that figure today, but we do have those figures.

Q276 John Robertson: Could you write to us and tell us exactly?

Mr Winn: Yes.²

Mr Lonergan: It is important to remember that fraudsters manipulate procedures for the movement of excise goods which are available to the legitimate trade and are laid down by an EU directive which introduced the single market in 1993. What that means is that if an exporter in the UK wants to send goods to Italy, they can do so without paying the duty. They have to comply with certain conditions and requirements, but basically the goods are allowed to travel to the other Member State without excise duty being paid. There is therefore an opportunity for fraudsters to obtain from legitimate suppliers goods, spirits, gin, vodka, whatever, on which duty has not been paid. One of the conditions which is important is that the goods are accompanied by a document which has to be received by the authorised destination, so that comes back as evidence that the goods have reached the other Member State and the movement is then deemed to have been fulfilled. What the fraudsters recognise is that because of the single market there is no routine Customs intervention at borders. So the traditional fraud is to take the goods out of the warehouse, divert them onto the UK market without duty being paid and then arrange for a fraudulent receipt on the document which was supposed to accompany the goods to the other Member State. Equally, the reverse can apply, where they buy goods from another Member State, accompanied by the document, they are brought into the UK and diverted onto the UK market and again the receipt on the company document is falsified and sent back.

Q277 John Robertson: How could you track that? A statement was made right at the beginning that it was not thought that one in six bottles were unfortunately stolen. How could you track back how many bottles or cases of whisky were going missing in that kind of thing?

Mr Lonergan: It is virtually impossible for anybody to say because of its nature: it is fraudulent business. You can only monitor legitimate business.

Q278 John Robertson: So you could not say that the government's statement of one in six is wrong.

Mr Lonergan: What is being said is that in the late 1990s, when fraud was definitely rife, the revenue losses from Customs figures were in the order of

² Not available at time of publication.

£570 to £600 million a year. The trade were well aware of it because of the impact on its business. The whole of the Scotch whisky industry, the gin industry, could see what was happening.

Q279 John Robertson: I say this because the Minister is coming in later and if we are going to hit him with it, I want to be sure.

Mr Rappoport: There are two very similar methods of estimating, one of which the government has taken, with one set of statistics. It is a gap analysis, so it has enormous variance. Incidentally, I used to be in the statistical service of the government so I look with interest on this. You are making very rough guesses as to what the consumption is. You are then taking the figures of what has gone through the system, which has paid duty. You take one from the other. The problem with estimating consumption is that you have to allow for people under-recording what they actually consume and all sorts of things. It is very, very difficult to do. Government took one set of figures and came up with £600 million and pretty level or even rising over the last few years. The Scotch Whisky Association, with the others, had a look at a different way of doing it, using slightly different methods, which I would say were at least as good and they came up with £150 million and falling, which, incidentally, the trade finds much more plausible, because we knew there was a problem some years ago which seems to have gone away. So it fits. The National Audit Office (NAO) looked at this and said that they felt the government figures were very dubious and they said it should be a much broader range. They looked at ours and said the whole thing was pretty variable. The fact is that a fair person reading the National Audit Office report would at least say that there was not much in it, or maybe it was slightly on our side. What we are therefore concerned about is that when you start looking at the regulatory impact assessment (RIA), it must accept that there is an alternative view. You cannot lay down the law and say it is £600 million. We are saying that there is a very valid question about that and if it is nearer the figure we have come up with, then the benefits in saving on fraud are less than the cost to the industry. That is why we are emphasising that.

Q280 Mr Weir: Coming back to what Chris was saying about the non-Sainsbury's side of the industry, I am still not clear. I accept that Sainsbury, Tesco, whoever, have a very tight distribution chain, little fraud possible within that. The question you are being asked is about the rest of it. What Customs say to us is that it is in the small independent retailers that they are finding this illicit alcohol where duty has not been paid. You are talking about various forms of diversion, but what can be done to tighten up that chain which would prevent fraud coming through if you accept that is the end where fraud is occurring in the small retailers and the independent wholesale business?

Mr Lonergan: The first thing to point out is that it is not usually the retailers themselves who are fraudulent. They are the buyers if you like. The

fraudsters are other people. Whilst there is talk about convoluted chains of supply, in reality if there were six or seven suppliers, they would not actually be different people, they would just be the same fraudulent gang masquerading under different entities. If you catch one, you catch the whole lot. The difference between what the trade is proposing and what Customs is proposing is that the main attribute of strip stamps suggested by Customs is visibility. In a retail shop or in a wholesaler you can immediately see whether something has a tax stamp on it. What the trade is saying is that surely, it is much better to prevent the illicit goods getting out of a duty suspension source like a warehouse in the first place. Rather than just dealing with the end result, you strive to prevent it. The trade suggestions are geared more to inhibiting the ability of the fraudsters to get hold of duty suspended goods in the first place, which we think is a better policy than allowing them to carry on what they are doing now and then simply counterfeiting stamps to counter the visibility.

Q281 Mr Weir: I understand that, but surely there is a responsibility on the end retailer to buy from a reputable wholesaler. Is part of the problem not that we are talking about these fraudsters, but if you are buying from a reputable wholesaler that should not be a problem? So there must be a case where retailers are buying from white-van man who turns up with whisky in the back of his van. Anyone doing that must know they are breaking the law.

Mr Lonergan: Quite likely. The thing is questions about who is liable for duty when goods are diverted. It is not the retailer. The actual law places the emphasis on the person who provides the guarantee for the movement and that can be an entirely innocent party. It could be any one of a number of producers.

Q282 Mr Weir: Is it not an offence to knowingly sell a bottle of alcohol on which duty has not been paid? Anybody buying alcohol in these circumstances must be assumed to know that it is not from a legitimate source.

Mr Lonergan: If Customs have the ability to tie that person into the fraudulent action, yes, they can take action. The number of people who are actually committing the fraud is quite low, therefore it would seem much more efficient and easier to show that they have committed an offence. However, we would still say that it is much more productive in terms of protecting the revenue and increasing revenue, rather than concentrating on an objective to prosecute fraudsters, to stop them actually developing the frauds in the first place. I have an analogy which I like to use: it is like me going to the police and saying the chap next door is beating his wife and a policeman saying "Leave it be, because eventually he will probably kill her and then we will really have a big criminal case". If you allow fraud to proliferate, you are doing the same thing.

Q283 Mr Weir: That is all very well, but surely if it is agreed that the problem is the retailer and dodgy wholesalers, then targeting these retailers who are

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found with the illicit alcohol and the wholesalers from whom they got it—and they must presumably have some information as to whom they got it from, otherwise they must certainly know they are dealing in illicit alcohol—that is another way to deal with it, rather than imposing it on the industry.

Mr Lonergan: One of the medium- to longer-term suggestions which the trade has made—not one of the short-term ones, one of the medium- to longer-term suggestions the trade has made—is in effect to clamp down on retailers. We did at one point suggest a registration system for retailers and wholesalers, the idea being that if you register something, so you cannot sell alcohol unless you are registered, then you find people selling it who are not registered and you can take action or, hopefully, deter people from registering because they do not want to be on official books. That was seen as quite an onerous task. There are many retailers and Customs might not be in favour.

Q284 Mr Weir: Do you mean a licence to sell alcohol?

Mr Lonergan: Yes, it is a sort of licence. There is Customs law which would allow a registration process which would amount to the same thing. The alternative idea, which is more cost-effective, was to use the Licensing Act 2003, which is due for implementation next year. We studied that and it has some possibilities, but despite it being written quite recently, it talks about things such as when a retailer is prosecuted for smuggling and that can be referred to the licensing authority, who could then review and revoke their licence under the Licensing Act. The problem is that smuggling is only one of a number of ways of committing fraud or being involved in fraudulent goods. That would have to be looked at again to see whether it can be beefed up. One of the other aspects of the Licensing Act is that various official bodies can demand a review of a licence with a view to revocation, but Customs and Excise are not listed. The Health and Safety Executive, the fire brigade, the police, child protection agencies are listed and Customs and Excise are not. It defeats me as to why they are not. One would think that would be an obvious thing to have in there, to help Customs and Excise, but it is a recently passed Act and it does not.

Q285 Mr Lyons: Would industry generally welcome that authority for people to withdraw a licence to sell alcohol if they were found guilty of committing fraud or illegally using spirits?

Mr Lonergan: I am sure they would.

Mr Rappoport: Absolutely.

Q286 Mr Lyons: Have you raised that with Customs and Excise themselves?

Mr Lonergan: It was part of our trade proposals, yes. It is not a Customs and Excise proposal.

Q287 Mr Lyons: No, I am saying with Customs and Excise.

Mr Lonergan: Yes, they have seen all these proposals.

Q288 Ann McKechn: You have indicated clearly the discrepancy in the National Audit Office report between the various statistics. Could you just clarify something? You mentioned that there was a problem in the 1990s when the Single European Act came in and you said that had now been largely resolved. Perhaps you could indicate what that problem was and how you thought it was resolved. In addition to that, looking forward, we are about to have ten new accession states join the European Union in May. The transportation networks of criminal gangs operating throughout Europe seem to be very extensive; they involve not only alcohol but also illicit drugs and human cargo as well. Given that there is no sign of those networks decreasing in their activity, would you not consider that there is a case, which has perhaps been made by Customs, for saying that fraud of this type, be it in alcohol or cigarettes, is actually increasing overall through the European Union rather than decreasing? That is why there is a need to think about alternative measures.

Mr Rappoport: The reason why in the middle 1990s fraud was a particular problem within Customs of how to handle cases, which Chris has already referred to, and there have been considerable investigations and this was what sparked off a lot of the reports into Customs, was that basically they were looking the other way while this happened in order to catch the big one, which is what Chris referred to. Meanwhile there was an awful lot of fraud and the industry was aware of it because you could see it disrupting lines of business. You could see this stuff arriving. That has stopped and Customs are much more on the ball now on this sort of thing. Now there is no market feedback that they can see fraudulent stuff appearing. That is why we feel that it must be coming down anyway. As to what will happen in the future, that remains to be seen, but Customs have already tidied up an awful lot of its act. Chris, maybe you would like to say a few words, because you were very close to this.

Mr Lonergan: If you look at the annual report of Customs and Excise, you can see, starting from about 1992–93, spirit revenue gradually increasing. It gets in 1995 to about £1.8 billion or thereabouts and that is when the major fraud started. It drops annually; it just falls and falls and falls, until 1998 when it was down to about £1.5 billion. That was perfectly transparent, because we knew extensive frauds were going on. In 1998, we managed to put a brake on the investigation methods which to some extent encourage this. If you look at the figures now, from 1998–99 spirit revenue has increased, increased, year on year until now it is about £2.2 billion. I think that is a fairly simple correlation to make between a change in emphasis and hopefully a reduction in fraud, because the revenue had gone up, in fact it went up £150 million in the last published figures to March 2003 and a comment was made that the Chancellor had his £160 million without even trying. Joking apart, it does show that the revenue has been rising steadily. Those figures are publicly available.

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Q289 Ann McKechin: Customs and Excise, in response to your own proposals, have stated that they do not adequately address this problem of inward diversion. This seems to be their fear, that there is a considerable amount of inward diversion into the UK and that your proposals are not going to resolve that. Goods are coming through the ports, someone is waving a false certificate saying they are going to such and such warehouse and it never turns up.

Mr Loneragan: What the trade proposal said was that the trade would work with Customs and Excise to develop procedures which were in the trade submission to limit that. As I explained earlier, these movements invariably come under the cloak of an official looking document, the required accompanying administrative document (AAD). They will invariably book space in a warehouse or contact a registered trader to give a legitimate address on the document. The diversion occurs when they simply do not go to that place and they send back a fraudulent receipt. One of the proposals is that any warehouse keeper who is contacted to book the fictional space should actually inform Customs within an agreed set of parameters and then report the failure of these goods to arrive. It will also hopefully be tied up with a live database and if the officers challenge suspect deliveries they can go into a database and check whether that warehouse has notified the imminent arrival of those goods. If they have not, if there is no record of this impending delivery, they can immediately seize the load and prevent it from moving. These are untried procedures, but they are being developed through the proposed memoranda of understanding between the relevant trade associations and Customs. The trade will obviously say that this would have an impact. If Customs say no, that is a difference of opinion. We also suggested the use of a machine which is in use in France which we have loosely called Enigma—it is a little box. We are told that this has been quite successful in France and is at a relatively low cost but it means that whereas now fraudsters can just write a receipt on the back of the accompanying document, and put some official-looking warehouse stamp, the warehouse will be the only people with a sophisticated machine which can contain as much information on its embossing device as Customs and Excise would like and would mean that any document which had not been through that particular warehouse machine could easily be identified. It is a proposal, so it has not been tested, but the trade is fairly confident this would have an impact not only on outward diversion, but on inward diversion in particular.

Q290 Ann McKechin: In other words improve the tracking and traceability of everything that is coming through the country.

Mr Loneragan: Yes, it would be transparent if the document had been falsely certified to say that the goods had reached that specified destination.

Q291 John Robertson: Could I direct these questions to Mr Winn and Mr Colvin? You have had an easy day so far, so it is your turn. You will import many brands of different types of spirit from around the world. How will the imposition of a tax stamp affect your business with your overseas suppliers?

Mr Winn: I can possibly answer that on two grounds. We currently import our own label cognac from a small supplier in Cognac in France. It is distilled and bottled there and delivered direct to us. We also import French brandy, which we handle through our own duty deferment account. The French brandy is a fairly large producer so the impact on the French brandy producer will probably be pretty much the same as the impact it will have on the likes of Diageo or a major UK or Scottish producer. On a small Cognac producer, it would probably seriously compromise their ability to supply the product, because they will have to purchase a small number of duty strips, have them exported over to France, apply these somehow, and as it is a relatively small operation, it will probably be done by hand, so suddenly employing more people will seriously affect the cost of the product. It is possible that we would cease to sell the product or they would not be able to supply us. On the question of goods such as our Russian vodka which is actually distilled and bottled in Russia, I have no idea how we would handle a product such as this. Bearing in mind the reported forging abilities of some of the eastern European states, Russia would possibly seem to be a prime source of getting fraudulently applied duty strips. There is a security aspect of sending strips all over the world, say to the Caribbean where we import rum from and Mexico for tequila. Okay, a lot of this is handled through importers on our behalf, but they would face the same problems we do.

Q292 John Robertson: Are these suppliers not supplying other countries which use tax stamps?

Mr Winn: There are not that many countries in the world which actually use strip stamps. I think the actual figures were enclosed in the Customs submission to you, as to which countries use strip stamps. This brings in another problem. Looking at something like our Spanish brandy, we already have a strip stamp on our Spanish brandy which is applied by local Conseco guaranteeing the authenticity of our Spanish brandy. What happens if we then have to apply a second strip stamp?

Q293 John Robertson: When you get a delivery of spirit to your stores, what do you do if one does not turn up?

Mr Colvin: The store would contact the regional distribution centre to query what has happened with it. It could be that it is late, has gone to the wrong store, but as soon as it leaves the gatehouse at the regional distribution centre, our systems send a message to the store concerned to say this is the stock you are getting, this is the vehicle, you are getting ten cases of whisky, five cases of such and such. So the store knows exactly what they are due to get. If they do not get that, it is immediately obvious because they should be booking in a vehicle and it has not

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turned up and was due two hours ago. They will then contact the depot which sends it out to find out what the problem is. They will then contact the driver to establish what has happened to that load.

Mr Winn: May I just be clear? When you say “store”, do you mean a distribution store or individual supermarkets?

Q294 John Robertson: Either/or.

Mr Colvin: What I am talking about there is the individual store as such.

Mr Winn: This arrives as a sealed lorry to the distribution centre with some Customs approved seal and they would only actually unload that vehicle if that seal is intact.

Q295 John Robertson: I asked the question because some time ago I remember asking a similar question of Customs and Excise and they said that a lot of the vans went missing before they even got out of the country. They would get down to a local service station and at that point the goods would go missing. My question would be, particularly if it were a delivery coming from abroad, they would send you a delivery, would you know whether it was another delivery or the same delivery?

Mr Colvin: We use specified hauliers and we have five major hauliers which do all of our imports. The supplier would say to us that the products were ready and we would send our haulier out to get that product and bring it back into the UK. In the main we are using our own certified hauliers.

Q296 John Robertson: If stealing from a service station happened, you would know about it.

Mr Colvin: We would know because it would be sealed at the supplier.

Q297 John Robertson: So you could audit trail it.

Mr Colvin: Yes. If a vehicle came into the bond or the regional distribution centre and it did not have the same seal on, we would know it was not the same vehicle.

Mr Loneragan: If I may say so, that would be theft rather than fraudulent diversion. The characteristic of fraud is that the person committing the fraud arranges the transport themselves; that is a key factor. When we talk about assessing risk, looking at parameters for what are potentially fraudulent movements, one of the key things is that the buyer arranges the transport rather than the supplier because the fraudster then can control it.

Q298 John Robertson: This is where the white van comes in. The white van gets loaded up and then goes to another distributor and sells it.

Mr Loneragan: Yes, but you see the point. The fraudster needs to have control of the transport, so they typically buy ex factory, ex works, because they then control the transport and they can say to the driver “Deliver it to Birmingham and not to Spain”. If it were a Sainsbury’s truck collecting it, something could go wrong, but it would be theft, it would not be a fraudulent diversion.

Q299 Mr Carmichael: What do you think the effect is going to be on your own brand whiskies, vodkas, whatever.

Mr Rappoport: We do not represent whisky, so it is over to Sainsbury’s.

Mr Winn: The own brand whisky market is highly competitive and you will find similar prices paid right across all of the major UK supermarkets. We are working on very narrow margins on such a product and the suppliers who are producing and bottling this for us are also working on very narrow margins. They can only really afford to supply us like this, because they are using our own label to maintain the almost 24-hour running of their bottling lines. The imposition of even a slight cost increase on that makes the viability of the operation somewhat suspect. Obviously our Scotch whisky is distilled in Scotland and we will bottle it in Scotland. We currently buy all our vodka from Scotland from one of the Scotch whisky suppliers. As Ms McKechnin suggested, we are about to see another ten new entrants into the EU with lower manufacturing cost bases, so suddenly it might become more viable for us to purchase white spirits in particular from countries outside the British Isles. There are lots of as yet unfathomed or unknown implications of the additional costs which tax strips will impose.

Q300 Mr Carmichael: What you are saying is that particular area of the market is working on very tight margins and this is going to have a serious impact on that.

Mr Winn: A serious impact. If the tax strip costs the same irrespective of whether it is on a £8 bottle of Scotch or a £40 hand-made bottle of extra special single malt. It has a disproportionately large impact on the own label market.

Q301 Mr MacDougall: In terms of the industry itself, what is your opinion about where the impact will be felt? Do you think small distillers and bottlers will be hit harder by this? Do you have some opinion of how strip stamps will affect the industry in general?

Mr Rappoport: Our opinion is that the impact of strip tax stamps, because of economies of scale and so on, will be much less on the big producers and that is not just whisky incidentally; we represent importers and will be on importers also. They mentioned the case of a large brandy producer and they will have a sizeable line of products coming to the UK and it is worth their while investing in strip stamps for it. For the small producer, it is a much heavier burden because they have the same cost outlay and a much smaller throughput. Incidentally, when you are talking in terms of single malts, it is very often a much longer time before it hits the market, so you can get all the financing costs. May I just mention one different side to this which has not been mentioned which is that imports have a similar, a parallel sort of issue, which is that the big ones are fine, but the small importers are also on very, very small margins and if they can persuade the supplier to apply strip stamps in whatever form they are at

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the origin, that is fine, but if you are importing a small amount of cachaça from Brazil or something very specialised they are not going to want to. The UK is a tiny part of their output, therefore you will get it without the strip stamp, you will have to break them open, put them on by hand and that is a very, very expensive procedure. Importers have tiny margins. They are not the basic producers who are where the margin is. They are tiny and this is going to be a very serious problem. As was said, what may well happen is that the big retailers will simply give up supplying those products and the consumer will end up with less choice.

Q302 Mr Hamilton: I am going to have to go out shopping again. I was thrown the other night by an £8 bottle of whisky. It has been a while since I have been in shops with my wife; I shall have to start going back. It is okay, I have Sainsbury's in Midlothian, but I share between Sainsbury and Tesco; I have to keep up with you all. The spirits industry put forward a number of alternatives to the tax stamp, such as tightening the guarantee system. Why do you think that Customs and Excise have not been convinced by your alternative proposals?

Mr Loneragan: The short and curly answer is that they are sold on strip stamps and therefore anything which was suggested as an alternative was unlikely to be deemed to have the same impact. The trade thinks that could be a very significant measure, because fraudsters rely on the fact that other people, be it a warehouse keeper or a producer, supply the guarantee for what will be a fraudulent movement. It is a mandatory condition. If the trade develops a solid commitment across the trade to avoid fraudsters shopping for people you might regard as a soft touch, that would leave the fraudsters exposed because they could not make a movement without providing the guarantee, because everybody else is saying they are not providing it. The difficulty the fraudster then faces is that these people do not deal in bank accounts; they like to deal in cash. Without a bank, saying yes, we think you are a satisfactory company, well established, reputable, therefore we will underwrite your guarantee, which is what Customs and Excise require, where do they go? They would in effect lose the ability to make the fraudulent movements they have been making. The irony is that by using somebody else's movement guarantee, let us imagine Howard were a warehouse keeper, Howard provided a movement guarantee for a movement which was subsequently diverted and the fact became known, it would not be the fraudster who would get the bill for the duty, it would be Howard, because the law says the duty liability falls on the person providing the guarantee. There is no real incentive to provide one anyway.

Q303 Mr Hamilton: Could I put it bluntly to you? Is it the case or do you believe it is the case that if Customs and Excise accept a number of the recommendations you make it would actually cost Customs and Excise more in time and money to

support that system, whereas the present proposal by the Chancellor effectively means that industry itself picks up the tab 100%?

Mr Loneragan: If you look through the proposals, I do not think that many of them would actually cost Customs and Excise a great deal of money. We talked informally about some of the work which Customs and Excise carry on at the moment, pointing out that some of their resources could be more productively used elsewhere. However, in writing our alternative we have given an endorsement to some developing ideas within Customs itself, because it is only fair to do that, but we are saying they should be given more weight. We are also suggesting, for example, that they get information from the warehousing trade about movements and develop their analysis of that. For example, we were saying earlier that if a warehouse is suspected of being used by fraudsters and Customs go in and invigilate and make it hot for the fraudster, if they move on, the information Customs gets from these warehouses on a monthly basis will show the level of movement to the EU plummeting at one warehouse, so Customs will realise that they have had an effect. All they need to do then is look for where the upward spike occurs and keep harassing the fraudsters, follow them round. It is possible to do an analysis.

Q304 Mr Weir: Will it also not require much more of an audit trail through all warehousing and retail to spot them in the first place?

Mr Loneragan: Customs tell us, and they have said this in the public meetings we have had, that they actually know who the major fraudsters are, that they know which of the warehouses they are most likely to use. What we are saying is that you go back to the basic position that it is much better to prevent the product reaching the illicit market in the first place. What we are saying is that the trade proposals address that requirement, rather than the requirement which says the goods can still merrily leave the warehousing system, be illicitly diverted, but they will be picked up, allegedly, by the strip stamp implementation.

Q305 Mr Hamilton: One of the bottling plants we visited, I think it was Bushmills, have indicated that they could have a number under the cap, a number at the back of the label and indeed a number embedded in the bottle. They also indicated that Tesco was doing a pilot run in relation to checking all materials which go into their shops from production to the point where it is sold. That is a traceable system which everybody can see. Is that likely to happen in the next couple of years?

Mr Colvin: Are you referring to RFID tagging, radio frequency tagging?

Q306 Mr Hamilton: I do not know the name of it, but it was indicated to us as a far better system than strip stamps.

Mr Rappoport: There is a system which is being developed and some pilots are being run for a new bar coding system. It is going to answer a lot of the

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questions, but I am afraid the timing is quite different. We are still working on it and it is going to be a voluntary system anyway. That may well be the answer to the problem, but it will not come in within the next few years. Although that would be a very good one, you have to wait a little bit for that. Incidentally, one of the problems with strip stamps is that you have then invested in the system and maybe it is unnecessary after a few years. Getting back to it, we were notified of this regulation which is coming in in the near future, which does demand traceability, but I am afraid it is not that sort of traceability. It is a much simpler thing. It does not indicate whether tax has been paid or not, which is the crucial thing. It is not influencing bar coding and it will not deter fraudsters. I am afraid that is something slightly different and it is more to do with tracing genetically modified product. What you are after is something which is coming along, but it will take a little time.

Q307 Mr Carmichael: Can I just pick up Mr Lonergan? Did I understand you a few minutes ago to say that in a meeting Customs and Excise had told you that they knew who the major fraudsters were?
Mr Lonergan: Yes.

Q308 Mr Carmichael: I did not just imagine that.
Mr Lonergan: No.

Q309 Mr Carmichael: Did they give you any indication what they were doing to catch these major fraudsters?
Mr Lonergan: They always imply that they see as a priority—and I have said this twice now—rather than taking immediate action to stop the movements, getting down the chain of supply and identifying—

Q310 Mr Carmichael: Mr Big.
Mr Lonergan: Yes; in a word, yes.

Q311 Mr Carmichael: I am not going to compromise your relations with Customs by asking you who told you this, but was it a high level indication from Customs?
Mr Lonergan: A senior manager.

Q312 Mr Carmichael: Did you form the impression that this was a casual remark or was there some substance to it?
Mr Lonergan: No, it was not a casual remark. I was not the only one there, so there are people in the trade who heard it. It was said in the context that they see the problem as getting these people into court and that colours the way they tackle the root problem which is the diversion.

Q313 Mr Lyons: We heard evidence last week that in tobacco traceability California have put proposals forward now which would give total traceability to any product which is sold in the state. Is there no way you could adopt that principle in bar codes to spirits? Part of the problem will be that if we are

trying to convince Customs and Excise and the Treasury we need a solid alternative and I have yet to hear that from you or any other party.

Mr Lonergan: The problem with any form of bar coding is by very definition it is put on at the time of production. There is the bottle, it is going down the bottling line and it is on the label. If that product is moved in duty suspension to another place and duty is paid there, there is no way that point of duty payment can be added to that bar code. Quentin mentioned before that as so far developed, these systems do not tell you where and when the duty was paid. It may be possible that some device or system could be developed to enhance that, but bear in mind that like strip stamps, if the stamps, the bar codes are not put on at the time of bottling somebody has to open up the cases, take them all out, put them through another bottling line to put the stamp on or do it by hand. Those are the sorts of issues which surround that sort of proposal. Would you agree, Quentin?

Mr Rappoport: Tobacco is a very different market. We are not really qualified to talk about tobacco but there you are into very major firms. You do not have as wide a variety of small firms. There are various other procedures but the time taken between manufacture and consumption is very much bigger, therefore you have all the warehousing and all the problems which can arise out of it, which in tobacco, by and large, do not apply. We are really not qualified to speak about the tobacco market, but I think it is a much simpler one from that point of view.

Q314 John Robertson: I have a bottling plant in my constituency and it has spent a lot of money on a new line. I have watched them put the strip stamps on in the bottling plant. Could you have two different labels, with either a different bar code or a hologram or picture within the bottling plant which could still be part of the assembly line when they put everything in? Could it be done that way?

Mr Winn: I can probably answer on this. If you are designing a bottling line from scratch you could actually put more than one labelling machine on the line and the latest labelling machines can apply up to four different labels during one pass. You do not have to apply all four labels to every bottle, you just apply the labels which are appropriate to that particular product. Obviously this applies to a dedicated, custom-built, high speed, modern bottling line, which you are probably referring to.

Q315 John Robertson: Absolutely and I am looking after their interests. Would that fulfil the needs of Customs and Excise?

Mr Winn: I would also support such a move, but the concern then might be the fraudulent refilling of the bottles subsequently.

Q316 John Robertson: That does not answer my question. Would it fulfil the needs of Customs and Excise?

Mr Winn: I cannot comment for Customs and Excise.

1 April 2004 Mr Andy Colvin, Mr Chris Loneragan, Mr Howard Winn and Mr Quentin Rappoport

Mr Loneragan: May I go back to what I said before? I would say what Customs and Excise would really like to be able to do is to say “That tells me that bottle is duty paid”. It will not do that because if the goods are moved out from the producer in duty suspension to another place, then that label will already be on there. If you wanted a further label putting on, you would have to take everything out of the case.

Q317 John Robertson: Could it not be done at the same time as the bottles were being filled?

Mr Loneragan: If necessary.

Mr Rappoport: May I just understand that I have the question right? Are you suggesting that instead of putting on a strip stamp you would change the label specifically and pay the duty upfront.

Q318 John Robertson: Yes.

Mr Rappoport: The strip stamp regime has not been defined in detail and there are various alternatives of which that is one to be explored. They have pros and cons. The difficulty with this one is that once you have stuck this label on, that bottle is worth £5. If you can refill it, you are saving yourself £5. There are various cons, but equally it might save something. We have to look through these. At this stage, it is just one of many alternatives which have really not been defined yet and we would hope that if it is going to go ahead it can be made flexible so that we can tease out the best way of doing it.

Q319 Mr Weir: Is it then the problem that the real problem with strip stamps is not so much the stamp itself but the fact that duty is going to have to be paid at an earlier stage at a cost to the producer?

Mr Winn: There are two aspects, both of which are equally of concern. One is the duty having to be paid at an earlier time; also the physical ability to apply strip stamps. I have had experience of applying strip stamps because as part of my role I have also—

Q320 Mr Weir: We have been through this before and we understand this point. John’s point is putting a label on a bottle. We have all seen the plants and putting a label on the bottle is a relatively simple exercise; it seems to me that if a label were to be printed in a different way that could be done quite easily and that would solve the problem of showing that duty had been paid but it would not necessarily

solve the problem of pre-paying the duty at an earlier stage. Is that really what it boils down to, that alternative systems would not get rid of the fact that you would have to pay the duty at an earlier stage than you do at the moment?

Mr Winn: Yes, it still remains a concern that the duty would be paid earlier than it currently is.

Q321 Chairman: May I thank you very much for your attendance today? Before we end this part is there anything you wish to add in conclusion, something we may have failed to ask which you think should have been included?

Mr Rappoport: You have very much covered the sort of ground we expected. The only thing I do want to say is that in addition to the size of the fraud, which we covered, is the impact, the way it may well cut off some of the variety to the consumer because the smaller importers and products will not be able to overcome the cost burden. The only other thing we have not really mentioned is the business about the incentive which this strip stamp will develop for forgery and theft. These strip stamps are going to be worth £5.50 each on a typical bottle. The cost of a strip stamp is estimated by Customs in their costings to be one penny each. There is a huge incentive not merely for theft of the bottles, which of course would get round all the problems of identifying them in the shops, because you would have ready-stamped products, but of the strips themselves. If you can go off with a book of these strips, you may well get £1,000. The hidden cost is the cost of policing that, of the bottling lines having suddenly to bring in a policing regime, which they have never had to before, because going off with a strip of paper is something quite different from going off with a bottle. That was the other point I wanted to add, but thank you very much indeed.

Mr Loneragan: I just want to emphasise that the trade view is that the alternatives are preferable. They fulfil the role of identifying what is normal, what is legitimate, which is the majority of transactions and thus identify, using parameters, what is abnormal and then concentrating both the trade and Customs’ resources on dealing with the abnormal people. This is better than having a measure which affects the legitimate trade in such a broad way.

Chairman: Gentlemen, I thank you very much for your attendance. Your evidence will be of great help to us when we come to making our report in the next few weeks. Thank you very much.

Letter to the Chancellor of the Exchequer from the Chairman of the Committee

THE PROPOSED WHISKY STRIP STAMP

As you will know, following your announcement in the Pre-Budget report that, in order to combat spirits fraud, a tax stamp may be put on all bottles of whisky sold, the Scottish Affairs Committee is undertaking an inquiry into the possible implications for the Scotch Whisky industry of such an action. So far, we have taken oral evidence from the Scotch Whisky Association and from HM Customs and Excise.

One of the main disagreements between the two sides is on the estimate of the level of fraud involved in the spirits industry; this difference has been highlighted by the publication today of the National Audit Office’s report *Estimating the level of Spirits Fraud*. Whilst my Committee, like the Government and the

Scotch Whisky industry, gives wholehearted support to tackling fraud in the spirits industry, I can only agree with comments made by the Chairman of the Public Accounts Committee, Edward Leigh MP, on the release of the NAO's report:

“Whilst I welcome the fact that Customs have produced fraud estimates to help them tackle the illicit alcohol trade, the National Audit Office has highlighted the extent to which current estimates of spirits fraud are riddled with uncertainty. This is as true of the estimates produced by Customs as of those produced by the Scotch Whisky Association. Clearly, it would be unwise for Customs to place too much reliance at present on their own figures . . .”

Presumably, your announcement in December last year about the possible introduction of a tax stamp in 2006, was made in response to the need to tackle a level of fraud of £600 million, as estimated by Customs. The NAO report has cast doubts on both this estimate, and on the industry's estimate of £100–150 million.

I would, therefore, urge caution in making any announcement in your forthcoming Budget Statement on ways to tackle fraud in the spirits industry which might be in reaction to uncertain data. My Committee was not totally convinced by the assessment made by either the industry or by Customs of the level of fraud, an uncertainty now clearly shared by the NAO. To base an important decision, which could have serious implications for a major UK industry, on figures which may be flawed and on which the NAO say further work must be done, would seem to be unduly hasty and unwise.

I am sending a copy of this letter to the Economic Secretary.

You will wish to note that I am making copies of this letter available to Members in the House of Commons Library and to the media.

11 March 2004

Letter to the Chairman of the Committee from Mr John Healy MP, Economic Secretary, HM Treasury

THE PROPOSED WHISKY STRIP STAMP

Following today's Budget announcement, I wanted to explain how we reached the decision to implement tax stamps for spirits and outline how we propose to take things forward from now.

The decision to proceed was not an easy one. The alcohol industry worked hard between the PBR and the Budget to come up with a new package of alternative measures, and I know they will be very disappointed with the Government's decision. Many of these measures have merit and some build on current or impending developments in Customs' operational approach to tackling alcohol fraud. However, after careful evaluation, we believe that the industry's alternative proposals would not be as effective in combating fraud as tax stamps. In particular, we judge that the industry package would risk displacement of fraud, leave the supply chain open to abuse by complicit parties, and do nothing to help the consumer and honest retailer to identify illicit alcohol. We concluded, therefore, that tax stamps promise an effective and proportionate response to the serious spirits fraud problem.

We have always recognised that tax stamps give rise to significant compliance costs for the alcohol industry. You will have seen that we are committed to offset such costs via a number of measures, including a spirits duty freeze for the remainder of this Parliament, assistance with capital investment and Government bearing the running costs associated with printing and distribution of tax stamps. I have also asked Customs to hold further discussions with the industry on the payment mechanism for tax stamps, where we will seek to implement the scheme without requiring upfront payment for stamps to minimise cashflow costs, and on other elements of the detailed scope and design of the tax stamps scheme. We will also, of course, publish a full Regulatory Impact Assessment alongside the Finance Bill.

I understand that our decision will also have disappointed you. However, I appreciate the consistent support that you and colleagues on the Scottish Affairs Committee have given to action to combat alcohol fraud. I sincerely hope that we can continue to rely on that support as we seek to develop a tax stamps regime that minimises costs and burdens on business and maximises effectiveness in the fight against fraud in the interests of the spirits industry as a whole.

I look forward to appearing before your Committee after Easter and I know members will want to question me closely on our decision and plans. I therefore propose to send you before my appearance a revised memorandum which takes into account the Budget decision and any subsequent developments, and which I hope will be helpful to you and your committee colleagues. I am copying this letter to John McFall as Chair of Treasury Select Committee for his Committee's information.

17 March 2004

Memorandum from John Healey MP, Economic Secretary, HM Treasury

INTRODUCTION

HM Customs and Excise submitted a memorandum to the Committee on 1 March explaining the nature of spirits fraud and how tax stamps would be effective in reducing it, and setting out the process of consultation and discussion with the spirits industry that has taken place since the Government set out, in the 2003 Pre-Budget Report, its proposals for an enhanced strategy to tackle spirits fraud.

The Chancellor confirmed in his Budget statement on 17 March the Government's intention to legislate for tax stamps for spirits to come into effect from April 2006. This memorandum explains the Government's decision to proceed, against a background of estimates of continuing significant levels of fraud, and its firm belief that tax stamps are the most effective and proportionate response to the problem.

THE NEED TO TACKLE FRAUD

The case for the Government taking tough action to tackle fraud and avoidance across the tax system is now firmly established, and the rewards from doing so apparent. The Government's strategy on alcohol fraud, especially spirits diversion fraud, follows its success in tackling losses in the other main indirect tax regimes, first stopping then reversing the trend of growing fraud in tobacco and oils, and now with indications of a sharp fall in levels of VAT missing trader fraud.

The Government welcomes the consensus across the spirits industry and other interested and affected parties that spirits fraud must be stopped, and the clear shared commitment to do so. That commitment has been reaffirmed since the Budget, and the Government's aim and intention is to continue to work closely with the industry, in particular on designing and implementing an effective and efficient system of tax stamps, and on introducing measures to offset compliance costs to the industry.

ESTIMATES OF THE SCALE OF SPIRITS FRAUD

Customs' estimates, published alongside the 2003 Pre-Budget Report, showed that around £600 million of revenue was lost through spirits fraud in 2001–02. In January 2003, the Scotch Whisky Association put forward an alternative estimate, based on a different set of data and assumptions, showing fraud at a level of £100 million to £150 million. In February, the Public Accounts Committee asked the National Audit Office to examine the basis for the differences between the estimates. The Government welcomed this work and the National Audit Office was given the full cooperation of Treasury and Customs officials in conducting it.

The NAO's report, *Estimating the level of Spirits Fraud*, published on 11 March 2004, recognises that measuring illegal activity is inherently difficult. It confirmed that Customs' estimate is reasonable but suggested that, given the high degree of uncertainty attaching to such estimates, it should properly be expressed as a range from £330 million to £1,080 million. The report also concluded that the estimate put forward by the SWA should be expressed as a range from £10 million to £260 million and is also reasonable.

The Government accepts that where there is fraud there will always be uncertainty about its scale. But this cannot be an argument against taking tough action to combat criminal fraud and protect the public finances.

THE INDUSTRY'S PACKAGE OF ALTERNATIVE PROPOSALS

In the Pre-Budget Report, the Chancellor announced that tax stamps would be implemented unless the industry could put forward alternative proposals that would be as effective as tax stamps in combating fraud.

The industry, through the Joint Alcohol and Tobacco Consultation Group (JATCG), worked hard and constructively to develop a package of alternative proposals, including risk-based notification of movements and transactions using Memoranda of Understanding, and tighter control by the trade on the use of their financial guarantees.

However, the anti-fraud impact of the trade's package falls significantly short of that estimated for tax stamps. As a whole, the package contains a number of inherent weaknesses:

- it would leave the door open to **displacement** to other types of fraud, most notably inward diversion;
- it stands to be undermined by a **complicit party**—a licensed alcohol trader within the industry in the UK or elsewhere in the EU acting in cahoots with, or turning a blind eye to, the fraudsters; and
- most importantly, it does not address the issue of **identification**—the ability for consumers, retailers and Customs officers to distinguish readily between licit and illicit product. The ability of fraudsters to mislead buyers into believing that supplies are duty paid is fundamental to the opportunities for, and profitability of, diversion fraud.

As a consequence, the anti-fraud impact of the package falls significantly short of that estimated for tax stamps. Based on the same assumptions about fraud levels, Customs cautiously estimate that tax stamps will produce additional revenue of £160 million in 2006–07. Using a similar methodology to that used for assessing the revenue impact of tax stamps, and with the same assumptions about fraud levels, Customs estimate that the industry’s package of alternatives would be unlikely to have an impact of more than £70 million a year once fully operational, and probably less.

Full details of the Government’s evaluation of the alternative measures will be included in a Regulatory Impact Assessment, which will be published alongside the Finance Bill on 8 April.

COMPLIANCE COSTS OF TAX STAMPS

The Government intends to implement tax stamps in such a way that additional costs to business are minimised, and measures will be introduced to reduce the remaining compliance costs burden further. Of the firms potentially affected there are 9 large, 15 medium-sized and circa 160 small firms. Although the bulk of the burden before offsets will fall on the large firms, the relative impact on small firms could be higher. Based on information analysed and agreed by the trade, the gross compliance costs (excluding any offsetting measures) are:

	£m	£/case (8.4 litres)	£/bottle (70cl)
One-off costs	23.2	£0.66	£0.06
Ongoing costs	53.9	£1.54	£0.13

These costs are broken down as follows:

<i>Capital costs (one-off)</i>		£m
> new machinery		15.4
> factory redesign		1.8
> other		5.9
Total capital costs		23.2

<i>Ongoing costs</i>		£m
> producers’ costs		16.5
> finance costs		23.8
> non-finance costs		7.0
> importers’ costs		4.0
> warehousing costs		2.6
Total ongoing costs		53.9

To help offset and mitigate these costs, the Government will:

- **seek to implement the scheme without requiring upfront payment for stamps—preventing increased cash flow costs and ensuring the trade continues to benefit fully from the facilitation offered by duty suspension and deferment.** This intent is subject to further detailed discussion with industry, and if, following further work, it becomes apparent that such an approach would be impractical or pose unacceptable risks to the effectiveness of tax stamps, the Government will examine other means to ensure cash flow financing costs, which make up over 40% of the trade’s estimated ongoing compliance costs, are minimised;
- **set aside a £3 million fund for assistance with capital investment,** targeted at the smallest firms, to offset upfront costs. Customs will have further discussions with the trade on the coverage, design and terms of the capital assistance scheme;
- **bear the full production and distribution costs** associated with tax stamps, estimated at 1p per bottle—reducing trade compliance costs by £5–10 million; and
- **freeze spirits duty for the remainder of this Parliament** to help absorb any costs that may be passed through into prices, meaning that by 2005–06 the tax on a bottle of spirits will be 36p lower in real terms than now—more than twice the estimated average cost per bottle of full compliance costs.

This freeze will cost the Exchequer £40 million in 2004–05 and £70 million in 2005–06. It means that, by 2005–06, on average the tax on a standard bottle of spirits will be £1.33 lower in real terms than if duty had risen in line with expected inflation since 1997.

The Government will also further examine likely security costs, and any scope for reducing these, as part of detailed implementation discussions with the industry.

NEXT STEPS

Full details of Government's evaluation of the industry's proposed alternative measures will be included in a Regulatory Impact Assessment due to be published alongside the Finance Bill.

Customs and Treasury officials have met the industry since the Budget through the JATCG to discuss taking forward the detailed design and implementation of tax stamps.

31 March 2003

Witnesses: **John Healey**, a Member of the House, Economic Secretary, HM Treasury and **Mr Nigel Pearce**, Law Enforcement Advisor on Alcohol Fraud and Smuggling, HM Customs and Excise, examined.

Q322 Chairman: Good afternoon, gentlemen, thank you for your attendance today. Before the Committee turns to specific questions is there anything you wish to add to your memorandum?

John Healey: May I briefly start by introducing Nigel Pearce. Nigel is the Customs enforcement advisor for alcohol fraud and smuggling. I have invited him along here, because his operational experience may be of benefit to the Committee. May I start by saying that I welcome the Committee's inquiry into the proposals for tax stamps, principally because it provides a focus for examining the concerns which are clearly there across all parties with the government's plans? It offers the potential of a parliamentary forum where you can take a balanced view of the government's proposals and the criticisms and concerns others have raised with them. May I say I look forward to the findings of the Committee and the government will take those into account when the Committee decides to make its recommendations? In the meantime, it is right to proceed with the legislation which we propose for the Finance Bill. The primary legislation which will be included in the Finance Bill will be the broad set of powers enabling us to set up the system and that will be followed by more detailed secondary legislation. I have given a commitment to the industry that, unusually, I shall ensure that we expose the draft Finance Bill clauses and any draft regulations to them before we publish them and before we lay them before Parliament. What I did immediately before joining the Committee was to authorise Customs later today, a week ahead of the publication date of the Finance Bill, to make sure the industry sees the draft clauses of the Finance Bill and sees the draft regulatory impact assessment which we shall publish on 8 April with the Finance Bill. If it is of help to the Committee, then I am very happy, later this afternoon when it is ready, to make that available to the Committee on the same private and advance basis as I am doing for the trade. Finally, the Chancellor made clear in the Pre-Budget Report in December that after nearly three years of very detailed discussions and work with the industry, we had come to the conclusion that frankly the other avenues which may be available for tackling the spirits tax fraud which we face have been exhausted

and that was why we were planning the legislation to introduce tax stamps which I have just mentioned. I know the industry were disappointed. In many ways they were entitled to be disappointed, but I would suggest that no-one should have been surprised. I believe also that no-one should encourage the false hope that somehow a magic formula for hitting this tax fraud as hard as tax stamps will do can emerge in further discussions. What I believe it is important for the government to do, and it is clear that the industry also accepts that, is to focus the detailed discussions now on designing and implementing a tax stamp system which is first of all as effective as possible and secondly minimises the costs to the industry as far as possible. The second of the areas of detailed discussions which is important now is the design of the measures the government are prepared to put in place to offset the costs to the industry in proceeding with tax stamps. On both counts, there have been formal meetings of the industry with the government and we have formally set up working groups of the industry and of the government to consider those two areas. That work is essential, it will be invaluable as we develop our plans and our policies further.

Q323 Chairman: Thank you very much, Minister, that was helpful. Just to clear the air before we start, we understand that there were questions on the floor of the House this morning and that you made some reference to the Committee travelling to Islay, to Bushmills and to Washington. We wondered whether you had any objections to select committees making extensive visits and inquiries.

John Healey: No, in this context it is a very good thing. Clearly as a Scottish Affairs Committee, part of your principal concern will be the Scottish economy and the Scotch whisky industry. The fact that you have set out a programme of visits and fact finding in other countries and in other parts demonstrates, for me at least, that the Committee is likely to take a view which goes beyond the concerns about the particularly Scottish based industry. I would submit that is after all an essential part of the territory we are examining now because a tax stamp

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system is a system for all spirits in the UK, whether they are Scottish based or based in the rest of the UK.

Q324 Chairman: Have you visited Islay or Bushmills or any other country in relation to this?

John Healey: No, I have not been able to. I have not gone to Islay, I have not visited County Antrim and seen Bushmills. At the invitation of Mr McFall, I have been to Allied Distillers in his constituency. I have also had direct face to face personal discussions with over a dozen companies, principally those involved in the Scotch whisky industry, but not exclusively.

Q325 Chairman: The National Audit Office are Parliament's watchdog in scrutinising public expenditure and I am sure you would agree that their reports command great respect for their thoroughness and total impartiality. Their recent report on the level of fraud in the spirits industry raised serious concerns about both Customs' and the industry's estimates of such fraud and says that further work must be done to ascertain a more accurate estimate. Would it not therefore have been wiser to wait until such a more accurate estimate of the level of fraud had been established, rather than introducing a measure which could have very serious implications for a major UK industry, in response to figures which may be flawed?

John Healey: I was pleased when the Comptroller and Auditor General offered to undertake this work for the Committee of Public Accounts; I welcomed it. I ensured that the Head of Customs wrote to him to guarantee the fullest co-operation from Customs and Treasury side. The NAO produced a balanced and important contribution to this. What they recognised unfortunately was that trying to estimate and assess the scale of an illicit activity, fraud, is inherently difficult. What they confirmed in their report was that there is a significant uncertainty about any of the figures which can be produced. What they said was that the Customs' estimate, the model we have been using now and publishing for three years, is reasonable, though they said we should regard it as a range which varies from £330 million a year to £1 billion a year. They also said that the alternative approach taken by the Scotch Whisky Association was reasonable and similarly could be expressed as a range which could go as high as £260 million a year. In those circumstances, when the public purse is being cheated by fraudsters of hundreds of millions of pounds each year, we have to take the view, and I think we are right to take the view, that no precision in the figures cannot be a reason for no action. We have a duty to safeguard the public finances and the revenues. We have a duty to try to stamp out the sort of fraudulent activity which is going on and which is also undermining legitimate business and having had two formal consultations and nearly three years of very detailed discussions with the industry, where we have looked at alternatives other than tax stamps, we have come

to the view that it is right now to move to put in place the legislative framework and the plans to introduce tax stamps which we would do from 2006 onwards.

Q326 Chairman: In your memorandum you state that Customs estimate that tax stamps will produce an additional revenue of £160 million in 2006–07. Presumably that estimate is based on a level of fraud of £600 million a year. If the level of fraud is £150 million, as the industry estimates, the extra revenue would be about £50 million. Is that right?

John Healey: If I may say so, we have covered this in considerable detail in the regulatory impact assessment, as you would expect. The assessment that £160 million would be saved from fraud from the first full year of implementation is indeed based on the Customs' level of assessment at £600 million. You and members of the Committee will see that in the regulatory impact assessment we have made an assessment of the likely impact of the alternative package of proposals which the trade have offered and we have done so on a similar basis. Clearly if the level of fraud is not £600 million a year and given the uncertainties we have just discussed it may not be precisely £600 million, then the likely revenue would be adjusted accordingly, but—and this will also be clear in the RIA—we have taken a very cautious view, which is the way we approach these things, of that figure of £600 million. It takes into account simply and principally the impact on the saleability of illicit alcohol with the introduction of tax stamps. It makes no allowance for the recovery of VAT revenues on illicit products, so by all calculations it is a cautious estimate, but it is indeed based on the Customs' assessed and estimated level of fraud. For comparability's sake we have used the same basis and the same assumptions in the regulatory impact assessment for assessing the package of alternative proposals proposed by the trade before the Budget.

Q327 Mr Weir: Could I ask you first about the National Audit Office? As I understood it they reviewed only methodologies between yourselves and the Scotch Whisky Association figures. But we heard in a previous evidence that when the same methodology was put to beer and wines they were product figures which were not credible. Is any reality check done on the whisky figures? We were told by the Scotch Whisky Association, for example, that the figure you produced would mean that every bottle of whisky in an independent retailer must be fraudulent which does not seem very credible.

John Healey: You will remember from the NAO report the inherent difficulties in sizing and estimating the scale of this illicit activity. What needs to be recognised is that gap analysis, which is what you are looking at here, is never going to be 100% accurate; it cannot be 100% accurate because clearly the assumptions which are part of making such an analysis can never be 100% reliable and accurate. Because of this, if the true gap, in other words the true scale, of fraudulent activity, smuggled or black market trading, is relatively small, then it is possible with fluctuations to get a negative figure. That is the case in the calculations and the approach we looked

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at with beer and wine. That is the reason for beer and wine, where the scale of the illicit market, the scale of the problem is of a different order to spirits, why we took the view that gap analysis was not a suitable method for us to assess the scale of the beer and wine illicit market. In a sense it does not undermine the methodology or the approach for spirits and it is based on the fact that unfortunately what we face with spirits is significantly greater than what we face with beer and wine.

Q328 Mr Weir: Given there is no doubt, even the industry accepts, there is some fraud, though the level is obviously in considerable doubt, can you explain to us why you believe strip stamps are the best solution? It was described to us elsewhere as a nineteenth century solution to a twenty-first century problem.

John Healey: I might bring in Mr Pearce here from a law enforcement point of view. Getting away from some of the theoretical analysis is quite helpful at this point and operationally the impact which strip stamps will have is quite important.

Mr Pearce: The biggest benefit of tax stamps is the issue of identification. In the other excise fields at the moment tobacco has a fiscal mark which allows the retail trade, members of the public, to distinguish between legitimate and illicit products. In the oil sector and diesel there is a red marker which is applied to rebated fuel, so again the buying public, the retailers, can distinguish between the two. With spirits there is no such indicator so this product can be sold openly through the retail sector. It is the identification which is the major benefit from an enforcement point of view.

Q329 Mr Weir: In the case of tobacco, which has been cited to us before, there is an inherent difference in that that—as I understand; I am not a smoker—is printed on the label. There are no additional costs to the industry as such. It is printed onto something which is going to have to be printed anyway. Strip tax is inherently different and if I understand correctly they are going to have to invest in new machinery, tax is going to have to be paid at an earlier stage and they are going to have to put these strips over the bottle, so there is a vast difference in that. Why is it not possible, if you are citing tobacco, to have something printed on an existing label to serve the same purpose, or the closure on the bottle, something of that nature?

Mr Pearce: The main weakness with a fiscal mark is that there is no direct connection between the payment of duty, the liability for duty and the actual product itself. With spirits fraud, the idea of diversion as opposed to smuggling which we have with tobacco, if we were only relying on a fiscal mark the product could still be liable to diversion. We would still be left with a product which bears a fiscal mark being diverted onto the illicit market. It could actually compound the situation.

Q330 Chairman: Would that not apply to cigarettes at the moment though?

Mr Pearce: It is mainly a smuggling problem with cigarettes, where the product is coming from overseas and we have the opportunity to intercept it at the frontier.

John Healey: We have explored some of this question of whether essentially the tax mark or the tax stamp could be incorporated as far as labels on bottles are concerned and we are prepared to look at that further. It does raise a number of other problems. It raises another problem in that it does not, like strip stamps over the top, have any anti-tamper provision. It also potentially introduces a whole set of additional security problems and costs for a very wide range of printers and designs the trade currently uses on bottles. It is not something we would discount; we are prepared to look at it. We have explored it to a degree so far with the industry. May I come back to the first and really most important question that Mr Weir asked, which is: why tax stamps? Essentially the prospect of tax stamps frankly kicks the legs out from underneath the fraudsters, both on the demand side and the supply side. On the demand side it will ensure that consumers and indeed retailers and wholesalers in the chain at the moment, will have an immediate and very clear visual sign that the product they are buying is indeed duty paid. They do not have that at the moment. What it means then is that any retailer or any trader cannot claim unknowingly to be dealing with a product which does not have duty paid. Certainly the other side of the demand side which is important is that if a bottle of spirits does not have a tax stamp on it, anybody buying that will be quite unwilling to pay a full rate, rather in the way that bootleg fags are currently sold at the moment. At present, there is no way anybody buying a bottle of spirits or a bulk purchase of spirits can tell and know for certain that duty has been paid. That is the first thing. That is the important side on the demand side. It is really what Mr Pearce has said about the importance of the identifier. The second thing is on the supply side. It would be impossible for a would-be fraudster to convince an honest alcohol trader, which they can at the moment, that they are dealing in duty paid goods if there is no stamp on them. What it means also therefore is that it will be much more difficult for the retailer to claim to Customs that they bought the goods believing the duty paid element was incorporated. In other words it would be much easier for Customs then to nail and to prosecute traders and retailers who could not claim that they were trading without knowing that the product was not duty paid. In other words, uniquely the tax stamps change the dynamic, change the market for the fraudsters. At the moment, with spirits, you essentially have for relatively low effort, for relatively low risk a really high profit, that is the nature of the dynamics of the market in which the fraudsters are operating. Introduce tax stamps and you make it very much more difficult for the fraudster. You make it higher risk, you make it more difficult and you make it lower profit and that is why tax stamps uniquely are likely to have the impact on fraud that we need to have.

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Q331 Mr Lyons: May I raise a question with you which we raised with Customs and Excise when they appeared before the Committee? The Scotch whisky industry, the Scottish Trades Union Congress, the CBI in Scotland, the Scottish Council for Development and Industry are all against the introduction of a tax stamp. Internationally, the USA have moved away and abolished them 20 years ago. Greece has abolished them. Mexico has made an announcement about abolition, Germany, Belgium, Norway have all abandoned plans to introduce tax stamps. What do the UK Government know that they do not know?

John Healey: I appreciate and understand why there is a range of views which would rather not see tax stamps. Frankly, as a government, we would not be planning to introduce tax stamps if there were an alternative approach which would have the sort of impact we need to have on fraud. We have been searching for that for nearly three years with the industry and we “ain’t” found it yet. One of the values of the Committee going to the States I guess is that you will have seen, I am sure, in any comparison between the US system of duty suspended movement and the European Union’s system, that it is a good deal tighter. It is a good deal tougher in terms of trade facilitation than the one we have in the European Union. It is a good deal less susceptible to the sort of fraud we see in the European Union and in the UK. It is not bound by some of the legal constraints we have in the European Union in order to be able to tighten it up. In those circumstances, and particularly in the 1980s where my understanding is that part of the impetus—you may or may not have established this when you were there—for abolishing the tax stamps in the US was to cut down the costs of the federal government at the time, then the situation with the US is not directly comparable. If I may say so, there are at least 40 countries which do have some form of tax or strip stamps. In some cases this is done essentially for quality assurance purposes for the products in a bottle, sometimes it is for tax stamp purposes. In many cases and in many countries, there are no or few design features built into the strip stamps which lend any sort of security. So they are capable of being counterfeited. In those countries which have taken the operation of their system of stamps seriously, having incorporated design features into their tax stamps that are security features, they report that has dealt with the problems they face. You will know of course that within our own European Union there are several countries which do operate a system of tax stamps and they do operate them in a way they regard as successful. I am thinking of Spain, Portugal, Italy, Denmark.

Q332 Mr Lyons: Yesterday you will know that the Scottish Parliament took a decision. Some of us thought it was physically impossible to unify the Scottish Parliament and you have managed to do that single-handedly. Of course we give recognition to that. In this successful motion they asked for the

Treasury to engage in further talks with industry to come up with an alternative solution. Are you prepared to do that?

John Healey: Immediately after the Budget we continued and shall continue the very detailed discussions and formal arrangements which we have for consulting and discussing with the trade. As I said in my opening remarks, I do not want anybody to have false hopes that somehow an alternative solution is likely to emerge. It has not over the last three years and there is no reason in my judgment to expect that it will do so over the next few months. The degree of detailed consultation and discussion with the industry is going to be absolutely essential and will continue, certainly from the government side, if we are going to design and implement a system of tax stamps properly, if we are going to be able to bring in a system of support for the industry which offsets, where we can, the compliance costs they face.

Q333 Mr Carmichael: We have got the message that your mind is closed, but it is still legitimate for us, as a select committee of the House, to assess the soundness of your judgment and to reach some conclusion in this. You are saying that you are conducting a regulatory impact assessment on a cautious basis, which takes the highest figure from a system of gap analysis which is not 100% accurate, but in fact is so inaccurate in respect of beer and wine that it cannot be relied upon. That is caution. The NAO have said that you have a reasonable basis, but so do the Scotch whisky industry, for assessing the scale of the problem. It is the scale I want to concentrate on for a second. What further work are you doing following the publication of the NAO report to refine and bring a wee bit more sophistication to the analysis of the scale of the problem you are facing?

John Healey: You will be aware that three years running we have published the details of the model we use, we have published the estimates we make of the scale of spirits fraud we face in this country. You may be aware that at the Pre-Budget Report in December we published the latest update of that and that included updated data, it included refinement to the way we did it and we shall clearly continue to do that. We shall also continue to look to ways we might validate or benchmark the estimates we have and we will continue to examine as well the sort of experience we gain from law enforcement operations to see the degree to which that is consistent with the sort of modelling calculations we do with the analysis. As you say, no system of estimating fraud can be 100% accurate, but you did say—and if I may say so, this was not correct—that the NAO said the Customs’ model and estimates cannot be relied on. The NAO said that they were reasonable and that they should be expressed as the range I indicated earlier on. It remains the fact that as a UK Government in a situation where the calculations we might all like to see greater certainty in are inevitably going to be difficult, are inevitably, as the NAO has made clear, going to have uncertainties in them, our duty is to say that a lack of precision about the

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estimates cannot be a reason for not taking action and that is why we made the announcement at the Pre-Budget Report that we intended to legislate. We wanted the industry to finalise work and we worked with them to try to see whether an alternative package of proposals could deliver the same impact. They could not and that will be clear in the details of the regulatory impact assessment which I shall let the Committee have. In those circumstances, reluctantly, but unsurprisingly, the Chancellor confirmed in the Budget that we shall press ahead with the primary legislation.

Q334 Mr Carmichael: If the scale of the duty fraud/ evasion continues to rise, why is it that in recent years the take to the Treasury of spirits duty has gone up?

John Healey: You will be aware, as well as anyone, that the level of consumption of spirits over the last ten years or so and in recent years has gone up very significantly, perhaps up to 20% of what in the Customs trade we call clearances for consumption. That has in part been driven by fierce price competition. It has in part probably been driven by the popularity over the last few years of ready-to-drink products. It has in part probably been driven by an increase in spirits consumption, particularly amongst the young. In a situation where we have increased consumption of a particular product, even where we have frozen the spirits duty in successive years, it has produced the revenue figures which we publish each year in the red book.

Q335 Mr Carmichael: This point about consumption increasing in the last ten years is interesting. It was about the mid-1990s, was it not in fact, that the take of duty to the Exchequer started going down? We were told earlier that in 1995 it was about £1.8 billion and by about 1998 it was down to £1.5 billion and now we are back up to a level of about £2.2 billion. Presumably we have a steady rise over that ten-year period, at the start of which the duty take to the Treasury went down and it has now recovered. Despite that you still think that duty evasion is a rising problem.

John Healey: Yes. Our evidence suggests it is. I would love it to be as simple as saying the revenues are rising on spirits duty to the Treasury, therefore the level of fraud must somehow be being brought under control and reduced. Unfortunately it just does not work like that.

Q336 Mr Carmichael: I am sorry. You have gone from £1.5 billion to £2.2 billion and you think that is down just to the fact that we are all drinking so much more.

John Healey: I am pointing out the fact that where you have a situation where consumption is rising, you are likely to get a tax take which is rising.

Q337 Mr Carmichael: Is it rising by 30%? Has it risen from 1998 to the current year by 30% while duty has been frozen?

John Healey: The levels of consumption on the various surveys and indices which are used suggest that consumption of spirits has been rising significantly in that period. You mention the mid-1990s and I have to say this is the period where, as far as we can tell, the fraudsters really started moving seriously into the spirits field. It was in part a product of the single market, the legislation which we touched on earlier, which set up the duty suspension and movement system in 1992. I have to say as well that it was in part a product of very savage cutbacks to frontline Customs staff during the early to mid-1990s.

Q338 Mr Carmichael: You know my views on that as well.

John Healey: One of the first things we did after coming to government in 1997 was to stop what was a further planned reduction in Customs frontline staff dealing with these sorts of frauds which numbered several hundred.

Q339 Ann McKechnin: Can I go back to the figures you have given for the additional revenue which you have estimated? Your estimate of what the Customs' proposals would give and the industry's proposals is about £90 million adrift. In your calculations have you made any allowance for the anticipated loss by counterfeiting of the stamps? If not, why not?

John Healey: The figures, as far as I am aware, do not build in an anticipated loss for counterfeiting. In my judgment that would be an assessment, the sort of refinement Mr Carmichael is encouraging us to make as we proceed. It would be at this point very difficult reliably to come up with an anticipated and numerical figure for possible counterfeiting, in part because the degree of risk and revenue exposure for counterfeiting will depend crucially on the way we design and the way we implement the tax stamp system. I mentioned earlier countries which have introduced some of the security features which help prevent that sort of fraud.

Q340 Ann McKechnin: The countries you have mentioned do not have the combination of factors which we would have in the UK. That is a very high value tax and a very large market within the European Union. The combination of those two must make it immediately attractive to the most sophisticated criminal networks in existence within the European Union. Would you agree?

John Healey: Clearly we have circumstances in the UK, although we are not alone within the European Union to suffer from this sort of alcohol diversion fraud, but we are incidentally one of the only countries which has tried to assess it, let alone put in place a systematic plan of action to try to tackle it. Clearly, where you have the potential, as we have in the UK, for the degree of duty, if evaded, to turn big profits for the fraudsters—and you will know that avoiding duty on a container of spirits can lead to a value of about £100,000—in those circumstances that is clearly a very lucrative and attractive market for the fraudsters. It is one of the reasons why the implementation of tax stamps would actually make

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it a good deal less profitable for the fraudsters to operate. In terms of assessing the risk and then quantifying the revenue consequences of any counterfeit danger, it simply is not possible to do that at this stage until we have a better idea of quite how we are going to design—

Q341 Ann McKechin: You have mentioned other European countries which operate a sophisticated strip stamp system. Surely they have given some sort of indication of how much they believe they have lost over the last few years, five years, from counterfeiting and you are saying in turn that you have made utterly no account of it and no assessment of that in your figure of £160 million. Say the figure for counterfeiting was £50 million, then the difference between your estimate of how much you could gain from the strip tax and the industry's proposals would be far less and then we have not taken into account the effect on the industry in turn.

John Healey: You make the point for me, if I may say so. There is simply no basis at this point for suggesting that the revenue hit for counterfeiting might be £50 million a year. We simply will not be in a position to assess that until we have a clearer idea of how we are going to design and implement the system and make the judgments off that.

Q342 Ann McKechin: Have you asked other European countries what their loss is?

John Healey: We have looked at the sort of systems and we have regular contacts, particularly within the European Union, about how Customs departments in those countries operate. I have to say that Sweden, as far as we have been able to establish, is the only other European Union country which has made any effort to assess seriously the scale of fraudulent spirits sales and alcohol sales in their country. Their latest figures were in 1996–97 and they recognise that one third of their alcohol reached the market in Sweden through illegal channels. In terms of those countries which have put in place the sort of features which I quite understand you and I would be concerned to see in any tax stamp system in the UK, it may profit the Committee to look at the example of Hungary, where our information tells us that they have built security features into their current strip tax stamp design which have meant that they do not, as far as they tell us, find that there is a problem with counterfeiting and fraud of the stamps themselves.

Q343 Chairman: You will be aware that when Ukraine tried to introduce strip stamps the counterfeit stamps were ready three weeks after the introduction.

John Healey: I am aware of those sorts of stories. In many ways, and I have seen some of these for myself, one has to say that the design of some strip stamps in some of the countries which operate them incorporate no security features at all and it is perfectly possible to get good copies from a photocopier frankly. With the Ukraine, in many ways I would suggest that it is not necessarily a good exemplar to compare with the UK. Many of those former Soviet states are bedevilled by levels of

systemic corruption and fraud which do not make them directly comparable, I would say, to a country such as ours.

Q344 Ann McKechin: May I just clarify then? The answer is that at this present time you do not have any figures from Italy, Denmark, Spain and Greece about the estimate of how much they may have lost on counterfeiting.

John Healey: I do not have figures on those. I will double check to make sure that Customs do not. For confirmation, it is not possible at this stage to make that sort of assessment in the UK with the prospect of tax stamps still a few years off. It is clearly something we will do.

Q345 John Robertson: Let us put the cards on the table here. The strip stamps are basically useless. You cannot get them to stay on the bottle; they fall off all over the place. Anybody who has been to Spain knows that when you pick up a bottle they come off in your hand. They mean absolutely nothing. I should have thought that a government such as ours could have been a bit more innovative in dealing with this problem. Is it strip stamps for strip stamps' sake and nothing else? Or, are you willing to look at innovative ideas which are going to come forward?

John Healey: The experience of countries which operate strip stamp systems suggests that they are not useless. Our assessment of their potential within the UK suggests that they would not be useless in terms of tackling the fraud we face. We have been and we will continue to be prepared to look at and discuss innovative ideas. However, I want to say again that we have come to this point after nearly three years of detailed examination and discussion with the industry about alternatives other than strip stamps for bearing down on this fraud. We have not, together with both sides and both minds applied to the problem, been able to produce the sort of approach which will have a similar effect on fraud that tax stamps would. In those circumstances, whilst we will—and you would expect us to—stand ready to explore any options which are put to us—I really do not want to mislead anyone with that statement into believing that somehow some formula that we have not thought of, or that we have not yet found, is likely to emerge, because I do not believe it will.

Q346 John Robertson: That is encouraging. I shall take out of it what I want to take out of it, but it sounds encouraging to me. I should also say that I have to tell you that Customs and Excise have not distinguished themselves in any shape or form when giving evidence to this Committee. I am afraid that we would be inclined not to listen to them too much and that would be my advice to you. Could I look at another part of the problem here and that is jobs? Anybody who has seen a bottling plant in operation knows that when the bottles get filled they go round and they keep going round until they get to the end of the system and they end up in a box. At what stage in a bottling plant are you going to stop to put on a

strip stamp? Do you know how expensive that is going to be? Do you know that it could actually close businesses throughout the country? If that is the case—and this is something the Treasury will have to look at—this could cause unemployment and you are going to lose tax revenue from another source and that is in unemployed people, people suddenly not having a job. Have you looked at the problem of small companies in particular who have small bottling plants and cannot afford to buy strip stamps and put them on bottles?

John Healey: Several questions in one, if I may say so. May I just be clear. If this Committee feels that it has not had the fullest information it needs or answers to questions which it wishes to pose to Customs or to Ministers, then I should like to make sure I know about that and I shall ensure you get the answers you require.

Q347 Chairman: We have had some reply to the questions we asked in detail when Customs were here and this is what we had in reply.¹ It is very, very far from adequate and we shall be seeking further clarification from them on it. We shall be happy to let you have a copy of it.

John Healey: Fine. If you would not mind letting me have a copy or perhaps, as Customs Minister, posing those questions via me, I shall ensure you get the best possible answers to the questions you might still have. I understand the fear about additional cost, I understand the fear about potential jobs impact in the industry. Those concerns have been put to me directly by many of the companies I have spoken to and by their representative organisations, including the Scotch Whisky Association. We have looked particularly at the potential position of small companies. The industry has done that as well and they have done a very good analysis of the likely compliance costs, not just the totals but also the relative proportions of costs which will be there for the big, the medium-sized and the smaller companies. If one looks at the spirits industry across the board, essentially you have nine big companies, big players in the industry, which produce more than one million cases a year. You have 15 medium-sized ones which produce between one million and 100,000 cases a year and then you have the majority, round about 160 companies, not just producers but those trading, who deal with fewer than 100,000 cases a year. The bulk, particularly of the capital costs, will fall on the nine big players, but it is quite right to be concerned that, relatively speaking, the burden for the smaller companies of making these adjustments may be relatively greater. This is particularly a concern within the Scotch Whisky Association and I recognise that. It is for that reason that part of the package of offsetting measures, which as a government we have given the commitment we shall consider, is targeted particularly to the pressures the smaller companies may be under. It is precisely that sort of further discussion that we are looking to have with the industry in order to be able to finalise essentially the

decisions we make about the amount and way and method of offsetting some of the compliance costs there may be for the industry but we are very much bearing the position of the small companies in mind.

Q348 Mr MacDougall: I was going to ask a question later on about the unscrupulous traders and what prospect that offered them in terms of strip stamps. It is probably a good time to mention that question right now because we are talking about the effectiveness of the proposals by the government. Could I just say to you that from what we have heard so far, it would appear from the industrial side of things that they want to find a solution to this problem and they do not seem to want to cause the government any problems at all. However, it is about effectiveness. How can you make the assumption that what you are proposing will have a meaningful effect on fraud as opposed to having a detrimental effect in the industry on jobs?

John Healey: The general answer there is that with any system such as this, and it would be true if we took the trade's proposals as well, there is likely to be a consequence and a cost on the industry for implementing anti-fraud measures. To a degree that fact is unavoidable. What we can do and shall do, and I have been very clear we shall do that, is look to design and implement the tax stamp system in a way which minimises the cost to the industry. Alongside that we will look to put in place a package of measures and support which helps offset the costs they will incur and will try to design a package of support to deal with the principal areas where the trade have told us and we have accepted that there are compliance costs in prospect. In terms of the effectiveness of the tax stamps, in a sense that takes us back to the discussion we had a little earlier about the way that tax stamps are likely to impact on the operations of the fraudsters, the way they are likely to impact on their ability to squeeze profit out of their illegal activities. Mr Pearce, is there anything else you want to add on that point?

Q349 Mr MacDougall: May I ask a further question first? I was very impressed by the presentation given to us in Bushmills when we were at that distillery, where I was handed a bottle of whiskey and they showed us the identification of that bottle of whiskey embedded in the glass, then they pointed out the stamp, etcetera; traceability was very much there. What you seem to be proposing can be duplicated very easily and put on the top of a bottle and almost give it authenticity, give it a legitimacy if they sell illegal booze, whereas what they were proposing seemed to be something much more readily identifiable. Why was that not acceptable?

John Healey: Just to be clear, are you talking about lot numbers?

Q350 Mr MacDougall: Any identification that they were proposing on bottles to make them traceable seems to be much more guaranteed than the prospect . . . If you can produce a £20 note and put

¹ See Ev 41-43

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it on the market these days, then I suggest you could put a strip stamp and duplicate that and put it on top of a bottle of illicit booze.

John Healey: We have looked at whether we could use any of the features which are generally increasingly used by the trade themselves in a sense to serve the purpose of a tax stamp. We looked at bar codes. Generally bar coding would not give us the ability to do this until probably significantly after 2006. We looked at lot numbers as well and the weakness with lot numbers unfortunately is that it gives you a degree of traceability after the event, but only to this extent. Essentially, as you will know, producers will have a lot number for a batch of production and that batch may, but it may well not, go to more than one or just one customer. At that point, that customer may then split the consignment and sell it on to any number of other customers. So the traceability after the event of simply using lot numbers is restricted really to that first stage of sale. The other weakness unfortunately of the system we have at the moment and I mentioned the constraints of the European legislation, of the system at present, is that what follows the spirits throughout the system is the accompanying administrative documentation. The format and content of this is essentially specified by the 1992 directive and that does not carry details like lot numbers. In other words, the further the product gets from the factory gates where it is produced, the more difficult, nay impossible, it becomes to use lot numbers to track it right the way back through the system. With lot numbers, it has to be said, once you get into the wholesale and retail system, there really is not at the moment an incentive for either the consigner, the seller of the spirits, or the consignee, the purchaser, to take any interest in the lot numbers. They are essentially an identifier which is there from the producer and the bottler. You might be interested in this, but I could circulate it. It is something I got the Customs people to dig out. It is essentially an example of an AAD.² You will see two things from this. You can see how rigidly specified and actually how limited the information about the product is which goes with the delivery. You can also see how straightforward and therefore how easily forgeable, because this is forged, the stamp is of the Portuguese warehouse to which this container-load was meant to have been delivered.

Q351 Mr Carmichael: We have high respect for forgers in this Committee. They know their business and that is part of our concern.

John Healey: The point I am making here is that the system we operate within at the moment of accompanying administrative documents and any refinements to that is limited by the European legislation and the lack of legal vices and it is easily circumvented.

Q352 Mr MacDougall: If at the end of the day the analysis by industry, not for self-protection reasons but for common sense reasons, is that there is a better way of securing the issue of fraud, would you be prepared to look at that again?

John Healey: Yes. It was the invitation in the exercise which we mounted before the Budget. We did look at the package of 17 combined proposals which the industry submitted before the budget. We have made an assessment of those and the detail is in the regulatory impact assessment which we shall publish on 8 April with the Finance Bill. Essentially our assessment of the fraud impact of that fell significantly short of that which we would achieve with tax stamps. On that basis it simply was not, I am sad to say, a credible alternative to tax stamps. If it had been, we would have welcomed it. We were looking for that. I can, if you wish, go into the general flaws of that package, but that also will be clear in the RIA. If the Committee would like to look at that I shall send it to you.

Chairman: Thank you very much, Minister.

Q353 Mr Lyons: All of us are united around the one thing, that we want to do something about fraud. Would you be surprised that Customs and Excise know who the major fraudsters are in this country?

John Healey: I have heard the industry say "Oh, Customs know the 20 Mr Bigs. Why do they not just tell us who they are and we'll have done with it". If that were the case, we would be concentrating all of our law enforcement attention on the 20 Mr Bigs, but it is not the case.

Mr Pearce: The context of that statement was that at that particular time we had an exercise under way where we had identified 20 suspects which we were very, very interested in. They were high risk suspects. The exercise at that particular time was focusing in on those 20. By no means were they the only 20 suspects; they were the ones we were interested in at that particular time.

Q354 Mr Lyons: What was the result of you making enquiries about the 20?

Mr Pearce: That work is ongoing.

Q355 Mr Lyons: Still ongoing?

Mr Pearce: Still ongoing.

John Healey: I hope this may assist the Committee. Customs at the moment have at least seven major investigations going on into large-scale criminal alcohol smuggling, particularly spirits smuggling. The nature and scale of the fraud is very often misunderstood, even by some of those in the industry. It is not entirely surprising. If you sit at the production end of this, the customers and trade contacts you deal with will have no connection with the fraud. If it would help the Committee, then I should be happy to organise a confidential briefing with Customs law enforcement intelligence and investigators and they could run through with the Committee on that basis the details of some of the investigations which are currently being conducted, the operations we are trying to nail and the Committee would have a very good idea from that of the scale of the revenue which is at stake in some of these operations and the number of complicit or frankly criminal parties involved. Some of these operations are, as with any major criminal investigation or fraud investigation, highly complex.

² Not published.

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It may bring home to the Committee quite what we are up against in a way that no written documentation can really do.

Chairman: I am sure we should be happy to take up that offer. Thank you for that.

Q356 Ann McKechin: You mentioned bar codes a short while ago and how your officers have looked at this. When we were in Washington earlier this week and we spoke to the enforcement agency over there for both alcohol and tobacco, they stated that individual US states' own tax stamps on cigarettes, which was a major area of evasion, were not adequate to combat fraud, as they were too easy to counterfeit. They said that the State of California is about to introduce new technology within the next year involving a smart version of the bar code, not the bar code as you see on these bottles of water here with the lines, but in a grid which would have embedded information in it and the enforcement officers could use a scan to track easily whether or not illicit cigarettes were being sold in retailers or warehouses or wherever. Our understanding was that there were about six different companies in the United States of America which are currently tendering for this type of work to the Californian state. Have your office been aware of that initiative or made any investigations with the United States about this type of technology? Would you be prepared to consider it as a method of using a tax stamp?

Mr Pearce: I think this idea was part of the trade's package of alternative measures. It was one of their longer term proposals. We are aware of the work which is going on. Parts of the industry in this country are leading in it. A couple of things to say. It is long-term; we are looking at 2006 to get the thing rolling in this country and it will be a lot longer after that before there is any really extensive use within the country. Second, for law enforcement, the real benefit would be to have the electronic chip showing the duty status. That is the key: the duty status of the product. That would indeed be a benefit for Customs. The big problem, the flaw, is that we would lose the visual identification that the members of the public, legitimate members of the trade, would want to use. That is where the impact of a chip like that would fall down when compared to the benefits of tax stamps.

Q357 Ann McKechin: You seem to have a thing about members of the public actually looking at the duty paid. If they go into a bar, they are not going to see the bottle, or it is going to be in one of those special holders. If they go into an hotel or club, in fact various sorts of places where illicit sales may be going through, they are not going to see the bottle. I do not know how many members of the public phone you up to say they think tax has failed to be paid on a cigarette, even with the duty paid certificate. It seems to me rather odd that you seem to rely on the fact of visibility. If someone put a special holograph stamp in a bar code and put next to it on the label "UK duty paid", as you do with cigarettes, then there would be some form of visual

identification. Is the problem not really about how you enforce the regulations and how many people are prosecuted, which actually provides a deterrent? That is what the public are looking for: regulations which are enforced and where prosecutions are made and where there is a deterrent. Is that not the priority?

Mr Pearce: Indeed; I would agree. The system we have at the moment is that the prosecution of retailers where we are able to find illicit product is difficult because we simply cannot prove a lot of the time that they were knowingly concerned in the supply of illicit alcohol. If there were a visual identifier on the bottle, then prosecution would be far easier.

John Healey: The short summary to your question about California is that if we do not have full details of what is being proposed in California, we shall make sure we get those just as the Committee has secured those and we shall have a look at them.

Mr Hamilton: Could I just follow up on that last part about an identifier on the bottle? One of the things which was talked about when we were in one of the distilleries and which I think is different from what you were referring to was embedding into the bottle the numbers or whatever and they could trace it right back to that point. If it is the case that it is only one penny or two to make a stamp which is valued at £5.50, the incentive for the fraudster is there to redistribute that, to copy it. The difference in having to do a bottle would be far more restrictive for any fraudster to try to get involved in. You are making great play of the fact that it is hard to get a prosecution, but you could get a prosecution if you had something embedded in the bottle, surely? I would see that, all the public would see, it would be embedded and if it were not there, then they would know it was a fraudulent bottle.

Chairman: Some of the bottle plants we visited had lot numbers embedded, etched on the glass, actually on the bottle, not in the label but on the bottle.

Q358 Mr Hamilton: Physically in the glass.

Mr Pearce: I understand. It is fairly similar to the discussion we had a while back about the fiscal mark. The weakness of that system is that with inward diversion that would have to be applied before the product came into the UK. It could still then be subject to diversion. The product could still find its way onto the illicit market. It would be marked and visually apparent to anyone looking to buy it "Legitimate. UK duty paid". Because there is no link between the application of the lot number or the fiscal mark to the actual payment of the duty, it would not necessarily be duty paid. That is the fundamental difference between the fiscal mark, which I think is what you are talking about here, and the actual tax stamp.

Q359 Mr Hamilton: The Scotch Whisky Association sets out several alternatives to the tax stamp. I know you have indicated that you do not have a closed mind if any other ideas come forward, but I think it is nearly there. You have not been convinced by any of the proposals which have been put forward. Can

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you expand on the reasons why you rejected those discussions you have had with the Scotch whisky industry over several meetings and indeed a number of detailed proposals they put? Why is every single one of them not practical?

John Healey: It certainly is not the case that every single one of them is not practical. The trade has asked us to treat them in aggregate, not pick and mix. The total impact of all the measures together would still produce an impact on the level of fraud which is significantly less than tax stamps. Essentially, the trade has come up with a mixture of proposals which has some potentially useful ideas with limited scope to hit the fraud, some which are already being pursued by Customs, some which frankly, as things stand in Europe, it would be illegal to operate and some of which, in our judgment, would be ineffective. We set out the analysis in the regulatory impact assessment. Essentially in the end there are three consistent flaws with the package. The first is that it leaves the field open very significantly for the fraudster to displace their methods, principally away from outward diversion to inward diversion, strict smuggling, perhaps moving on much more to the Registered Excise Dealers territory. That is the first problem. The second problem is that even tightening the system in the way that the package of proposals is designed to do, it would still leave the system susceptible at any stage to a complicit dealer diverting the goods. Thirdly, what it lacks, what we have been discussing principally, what the tax stamps offer, is the visible indication to the customer, the retailers, the Customs officer that here is a bottle of spirits on which the duty has been paid or secured. The package of proposals just does not deal with that unique advantage which tax stamps would have.

Q360 Mr Hamilton: Let me put this to you. At one of the bottling plants we visited it was put very forcibly by one of the manufacturers: what more does the industry have to do? What additional proposals or safeguards do they have to come up with, what additional assurances can they give you, in order to avoid the imposition of the tax stamp? They were basically saying: tell us what we need to do to avoid the imposition. What do they need to do to convince you?

John Healey: The Chancellor was very clear in the Pre-Budget Report in December. It was an invitation to the trade and we worked with the trade where we could as well, to come up with an alternative or a set of alternatives which would have a similar impact on the levels of fraud which we face in the UK. If they could do that, then that for us would be a viable alternative to proceeding with tax stamps. They worked really hard at that and I pay tribute to the work they have done, but frankly the package of proposals unfortunately did not pass muster.

Q361 Mr Hamilton: Is it the case that a number of the proposals which were put forward actually meant that Customs and Excise might have to do a bit more and that would cost the Treasury a bit more money?

John Healey: No.

Q362 Mr Hamilton: This way you are making them pay for everything.

John Healey: Emphatically not. Over the last few years we have increased the resources and the personnel Customs are deploying to try to tackle alcohol and spirits fraud. We shall continue to do that as is necessary. You will have seen the package of measures and support the government are prepared to put in place to try to help deal with some of the compliance costs. That is a very significant hit on the exchequer. There is also the commitment the Chancellor made in the budget to freeze duty rates on spirits for the remainder of this Parliament. It may be discounted by some in the industry, but let me be clear to the Committee that this next year is going to cost the exchequer £40 million doing that. The following year it is going to cost £70 million. The concern you have is not the case, that somehow this is a way of putting all the onus on the trade and the problem and the reason for doing that is somehow that we do not want to give Customs the resources or the exchequer the cost of an alternative approach.

Q363 Mr Hamilton: So Customs are not involved in the cutback in the civil service which is being talked about, is that right, when the amalgamation takes place with the Inland Revenue? Is that what you are saying? Is there not going to be a cutback?

John Healey: No. It was a central part of the Budget statement that Customs, like other government departments, are going to deliver efficiency savings and a reduction in the number of posts over the next few years required to do their job. In a sense this is nothing new for Customs. With the changing nature of the challenges Customs face, with the changing demands and expectations of taxpayers, including businesses, it just has to be the case that they change the way they operate. We have done that over the last few years. For instance, we set up the National Advice Service. Instead of 38 sites offering advice and information to taxpayers, it has been consolidated into six. We have set up the national co-ordination unit to support frontline officers. We have reworked, particularly in the central region and the south, the deployment of law enforcement, intelligence and investigation and detection officers. In each of those cases it has been driven in part by the demands on the department, in part driven by our ability, particularly with new technology, to cut out some of the back office manual processes which go on and it has allowed us to invest more in the frontline, fraud tackling, anti-smuggling, intelligence and detection, VAT assurance staff and that is what we shall continue to do. The Chancellor confirmed in questions today, as he did in the Budget, the scale of the posts which Customs will be able to take out over the next few years. The purpose of doing so, for us as a Labour Government here, is so that we can re-invest those resources into the frontline. Some will be re-invested into the Customs frontline; others will be part of what we as a

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government will be able to re-invest to beef up further the frontline in schools, hospitals, policing and community crime.

Q364 Mr Carmichael: You have spoken about the visual impact of this strip stamp and if I understood you correctly you are saying that is what sets your proposals apart from all the other options there are to be pursued, including those from the industry. Is that a fair point?

John Healey: It is one of three. It is a significant feature, but it is not the only feature.

Q365 Mr Carmichael: Mr Pearce was telling us today about the printing of a fiscal mark on cigarettes and indeed we heard evidence from your colleagues in Customs and Excise at the last session that was one of the reasons why they thought this was a workable option, the fact that they had used this printed mark, which is different but similar, on cigarette packets. I was told recently that in fact there is now an escalating problem with counterfeit tobacco and counterfeit tobacco packs, to such an extent that the National Audit Office are now conducting their own investigation into that. Is that the case?

John Healey: I can certainly check, but I do not know whether the National Audit Office are looking at the question of counterfeit tobacco.

Q366 Mr Carmichael: And tobacco packs.

John Healey: What is certainly the case is that the tobacco industry is extremely concerned, as we are, about what appears to be a rapidly emerging trend, where a greater proportion of the illegal and illicit tobacco and cigarettes coming into this country is not simply without any duty paid, but is actually counterfeit product of established brands. Clearly we share a very active interest with the four major tobacco manufacturers in this country in trying to stamp that out. It is certainly a significant problem.

Q367 Mr Carmichael: It is presumably not duty paid, so it is the same issue. Mr Pearce, are you aware of the NAO investigation.

Mr Pearce: I am afraid I am not. Tobacco is not my field.

John Healey: It is not entirely the same problem, if I may say so. Clearly part of the counterfeit operation is about how they manufacture and print the packaging, but the other area of principal concern, and this is not similar to the alcohol field, is that the product itself, the tobacco and cigarettes are counterfeit. That is not a problem we have generally within the spirits field.

Q368 Mr Carmichael: Do you not think it undermines the reliance you put on the importance of a visual mark though?

John Healey: No, I do not think it does. We regard tax stamps as a workable option.

Q369 Mr Carmichael: I know you do.

John Healey: For two principal reasons. The first is that there is experience in some countries which have designed and incorporated their tax stamps in a way which does build in security features, which gives us some confidence that you can deal with the problem of counterfeiting of stamps. The second is that in some of the early discussions we have had with leading security printers, there is a degree of assurance that they are prepared to give as part of potentially being interested in this business which would give us, as a government, and would give the industry, a much greater degree of confidence that we can do this in a way which makes it very much more difficult and minimises very significantly the risk that these things are going to be produced in a counterfeit way.

Q370 Mr Weir: I just want to follow up on this question of visibility. On several occasions both you, Minister, and Mr Pearce have mentioned the visibility aspect, in particular you mentioned the fact that the consumer could see the stamp, the retailer could see the stamp. We have talked about counterfeiting. How many consumers or even retailers are going to be able to tell the real stamp from a counterfeit stamp? Given that all the evidence we have heard so far is that the problem is not at the distillery end but at the retail and distribution end of the market, I do not see how this visibility is going to help in any way. Surely anybody who is buying in the retail sector, who is buying alcohol from a non-recognised wholesaler, knows exactly what they are doing.

Mr Pearce: The key here is educating the public and the trade at the time of the implementation of tax stamps as to how to recognise a genuine tax stamp and what it represents and what they should do indeed if they find unstamped product. I am sure there will be some very poor counterfeit stamps, just as I expect in time there to be some very good ones. I would hope that the security features we incorporate in the stamp will allow the average member of the public to identify the poorer counterfeits which do come along.

Q371 Mr Weir: Given that the average member of the public probably could not tell you which a counterfeit £20 was as opposed to a real one, why is it going to be any different with strip stamps?

John Healey: I would say that most retailers and shop staff are reasonably good and there is some very straightforward countertop technology which helps them identify counterfeit currency notes.

Q372 Mr Weir: There are still millions of them in circulation.

John Healey: May I pick up one further point in your first question which is the suggestion from what you said that somehow this problem may be confined to unregistered operators. One of the important cases which I want Customs to be able to brief the Committee on involves eight connected investigation cases. It involves 311 container-loads of alcohol which have been diverted. In each case,

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the players involved have been registered in this country and elsewhere in Europe. So the registration itself is not a guarantee at the moment of no involvement in fraudulent activity. It is not simply that our system is only being subverted by those who are not approved or who are not registered by the system we have in place.

Q373 Ann McKechnin: You have mentioned the Budget's proposals for assisting the industry in terms of the compliance costs. However, is it not the case that there is a limit to the financial assistance you can give to the industry, particularly under EU competition rules, which I understand prevent you from giving more than €100,000, about £67,000, to a bottling plant to help them with buying a new machine capable of putting on the strip stamps? We understand that currently the cost of such a machine is up to £¼ million plus. There would have to be one for each bottling line in a plant, so for some plants more than one machine may be required. What are your views about whether or not the assistance given is actually going to have a significant effect, given the likely cost of the machinery?

John Healey: The short answer is that if we get this right it will be of very significant assistance. Getting it right involves further detailed discussion with the trade. The area of potential support you identified is just one of a number. It relates, you are quite right, to the current European Union state aid legislation which will allow government, without falling foul of state aids, therefore being seen to distort competition within the European Union, to give to any firm over a period of three years up to €100,000. That is the case irrespective of the size of the firm. Clearly if you have a flat rate grant which you are prepared to make available to assist with set-up costs, it is likely to be proportionately more valuable to the smaller producer and the smaller operation than it is to the larger one. In terms of the new machinery which you are concerned about, the analysis the industry has done, which we have gone over with them and have accepted and agreed, suggests that with machinery and capital investment, the one-off first year costs, the large investment and the expensive investments are going to be made by the big companies I talked about earlier. So those nine largest firms in the industry are likely, according to the costs the industry have produced and which we reproduce in the regulatory impact assessment, to be looking at £12.8 million. That is £12.8 million out of a total capex cost of £15.4 million. That is more than 80% of the capital expenditure costs which are likely to be borne by the nine biggest players. In those circumstances you could perhaps see how that element of a potential offsetting, compensating package to the industry is going to offer relatively greater help to a small company faced with some capital expenditure than it will to the Diageos or the Allied Distillers of this world.

Q374 Ann McKechnin: When we looked, for example, at the case of Bushmills in Northern Ireland, part of Irish Distillers, which in turn are part of Groupe

Pernod Ricard, they regard their operation in Ireland as an entity. They currently have three bottling plants, two in Eire, one in Bushmills itself. They are going to be closing one shortly in Eire, but the one in Dublin is the only one between them and Bushmills which actually already has a strip machine. In other cases, where we have visited bottling plants or we have received evidence, there is evidence of very aged bottling machinery around. Do you not consider that there is a real danger, because bottling plants are where the majority of the jobs are in the whisky industry, that either they could be moved to other plants, for example in the Bushmills case, or alternatively, given the costs which are going to be involved, the major distillers may well look at outsourcing the bottling outwith the UK to where the labour costs may be less expensive?

John Healey: It is fair to say that one can only estimate and anticipate the likely response within the industry and it will be different from company to company because clearly different companies will have a different set of circumstances and competitive pressures which will inform those decisions for them. There will be an opportunity within this. Our assessment suggests that just under half of the spirits imported into the UK is likely to have the tax stamps applied in the UK, so that would be new business available to companies in the UK; there is an opportunity there. You are quite rightly concerned about the costs. In the case of Bushmills, particularly in the County Antrim plant, the concern is that the company itself might choose, for commercial reasons, to do its whole bottling and tax stamp application in Dublin rather than in County Antrim. I recognise that there will be particular pressures and decisions which some of these companies will take. There is a limit to how far we can second-guess that. What I would say, and I have said this to other Members who have concerns about operations in their constituency, is that we have worked with the industry to produce the estimate and the analysis of compliance costs. What I am keen that we do is cross-check or verify that, where there are particular individual firms who are prepared to disclose the plans and potential costs that they think will be involved in tax stamps. I am very happy, and I have made this undertaking to other Members, to look at the details which individual firms are prepared to supply, in part to assess, in part to scrutinise, but in part also to verify whether or not the individual firm and our joint assessment of the overall compliance cost and the likely distribution is indeed as accurate as it can be. In the case of Bushmills in particular, I should be interested if you, the Committee, or the local Member wanted to let me have the details of the issues faced by Bushmills.

Q375 Mr Lyons: May I go back to the question of counterfeiting? An article in last Sunday's paper, *Scotland on Sunday*, referred to a letter which had been sent by Drew Samuel, who is the Managing Director of Gavin Watson, not just a leading security products company, but very well respected. The claim was made that he had written to Customs

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and Excise on this question of counterfeiting machines readily available in China for the production of strip stamps when they come along. Can you confirm whether that letter has been received by Customs and Excise?

John Healey: As it sounds as though it was addressed to Customs rather than to me, I would need to check that, but I shall check that.

Mr Pearce: No, I am not aware of it personally.

John Healey: Let us be clear. Mr Pearce would not deal with correspondence necessarily on the law enforcement side. Essentially he and his team are operational. He would not necessarily see correspondence.

Q376 Mr Lyons: The correspondence claimed that there were at least 25 major manufacturers in China ready to supply these machines on a no-questions-asked basis. It raises the question, not just about counterfeiting the stamp itself, but if you have machinery which is capable of providing that type of stamp, why put it in an authentic whisky bottle. Why not just provide a low quality whisky yourselves? You will really make a killing in terms of money. Is that not a danger?

Mr Pearce: It is a danger, but in our assessment not a great one. There is currently a minor problem with counterfeit product, which is not only a problem for the industry in terms of brand protection, but also public health and that would be of great concern to us. The one difference normally found with counterfeit product is that it is either distilled in this country and therefore is relatively far easier to detect, or it is smuggled in and never actually gets into the legitimate duty suspended supply chain as does legitimate product. With a smuggled product, it is relatively—I say relatively—more straightforward to detect at the frontier when it is being brought in. I would hope that we would be in a much better position to detect that product coming into the country than we would with product being moved within the duty suspension system.

Q377 Mr Hamilton: The Minister has already indicated that he knows he has to screw industry and raise revenue, that is not what we are about. One of the things you indicated in answer to the previous question, which I thought was very helpful, was about the capital cost and assisting companies with that cost. One of the big major factors, and it does not matter whether it is a big distillery or a small one, has to be the ongoing cost, because they will have to look at additional labour and indeed there will be a massive reduction. For example, in one of the bottling plants it is impossible to do 500 bottles and you stretch that machine to the end of it. When you go to the small companies like on Islay, there is a developing company where they have a bottling plant beginning to develop, they would have to re-look at the ongoing costs of bringing people in because by the very nature of strip stamps there would be more wastage and they would have to come back on that. When you look at the capital cost

of the assistance you are going to have to be talking about, will you also be talking to the companies about the ongoing costs they have to take on?

John Healey: Yes, and part of the work industry has already done and done with us to verify covers, as you quite rightly say, not just the one-off costs, the set-up costs in the first year costs, which we total to be just over £23 million, but the ongoing annual costs, if no offsetting measures are put in place, and they total just under £54 million. You are quite right, there are several what we would classify and will confirm in the RIA as production costs. In part that is about extra materials they may need to buy, which they do not need to buy now, for the strip stamps operation. It is also about the loss of running speed and therefore efficiency which has been built into the compliance cost calculations. The production cost element also, because we asked the trade to look at this in these terms, included the cost of printing and distributing the tax stamps themselves. The Chancellor confirmed at the Budget that rather than that being a cost which the industry would bear, which it often is in other countries, that would be covered by the government, by Customs at no cost to the industry. The other and most significant feature of the ongoing costs which the industry estimate will be there for compliance is that over 40% of those annual additional costs are finance costs. Principally this is about the potential cost of increasing the working capital which companies would have if they had to pay for the strip stamps up-front. You will be aware that the Chancellor has also made clear, and I have as well, that we will look to try to introduce the system of tax stamps in a way which means that people who use them, need to purchase and apply them, do not have to pay for them up-front. If we can succeed in doing that, then we take out nearly 40% of the ongoing annual costs to the industry as part of the compliance with the tax stamp system.

Q378 Mr Carmichael: When Customs and Excise officers gave evidence to us, they told us about an exercise in which 300 retail premises in London had been raided and 143 of them, if I recall correctly, were found to have spirits in respect of which no excise duty had been paid. One of the points they made was that there is a difficulty in prosecuting these people because it is an offence of knowingly intruding with these non-duty-paid goods and indeed that is the case as I now understand it, although I see that there is a section 170A which allows for the recovery of civil penalties in respect of similar offences and these are strict liabilities. My question to Mr Pearce is first of all: in these 143 cases were any civil penalties recovered? Second, if the point is about the offences under the Customs and Excise Management Act being so difficult to prosecute because they are offences which require a guilty knowledge, as government why do you not change the law to make them strict liability offences, perhaps with an offence of due diligence?

Mr Pearce: To my knowledge, we did not apply any of the civil penalties under section 170A in any of the cases to which you refer.

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Q379 Mr Carmichael: Why was that?

Mr Pearce: The reason is that we have at our disposal a number of other sanctions which we can use, including section 170, civil penalties, and including where possible criminal prosecution. The other sanctions which we did employ are of course seizure and non-restoration of the goods. In a number of cases, again where we were able to identify guilty knowledge, we were able to seize vehicles which were either loading or unloading, sometimes storing, the product. That particular exercise was a multi-agency exercise involving the Metropolitan Police, Trading Standards Agency and licensing officers. The licensing officers, where there was evidence of complicity with the retailer, have taken away the information to weigh up against their next renewal of the liquor licence. Given that there are all these other sanctions which we can and do use, in those circumstances it was not considered appropriate to use—

Q380 Mr Carmichael: Not one of them had a civil penalty imposed.

Mr Pearce: No.

Q381 Mr Carmichael: Minister, on changing the law.

John Healey: We may not look to change the law in that particular way on penalties. Part of the discussion we shall have within this House during the passage of the Finance Bill and then subsequently in any regulations which bring the tax stamp regime into place will be about the appropriate level and regime for penalties which need to be put in place to underpin the tax stamps regime. That is an issue I know we are going to be debating.

Q382 Mr Carmichael: Surely though, if there were a prosecutable offence, that would be an obvious way of drying up one of the major outlets for duty evaded whisky without putting the burden onto the distillers who are by common agreement not the people who are responsible for the duty evasion.

John Healey: The principal players, the guiding minds in these frauds—

Q383 Mr Carmichael: That is why I am suggesting you make it a strict liability offence.

John Healey:—are not the ones selling these bottles to the punter on the street.

Q384 Mr Carmichael: The people selling it to the punter on the street though would be much less inclined to do so if they thought there was some realistic prospect of them being taken to the court and given a serious punishment, which does not exist at the moment.

John Healey: You are dead right. One of the problems at the moment, as Mr Pearce was trying to explain, is that in those 143 cases—and you are correct about the figure of 300—in order to take them to the courts, in order to prosecute, we have to be able to demonstrate guilty knowledge.

Q385 Mr Carmichael: So change it. You are the government: change it.

John Healey: With tax stamps that becomes a good deal easier.

Q386 Mr Carmichael: But the tax stamps put the burden onto the distillers.

John Healey: Nobody can buy and re-sell bottles of spirits without a tax stamp and claim that they were not aware that the duty was not paid.

Q387 Mr Carmichael: But tax stamps put the burden onto the distillers. What I am talking about is striking at the people who are the end chain of the problem. Why are you not doing that first to see what impact that has?

John Healey: It is a part of the picture, but the principal problem does not lie at the end of the chain, just as it does not lie at the start of the chain with the producers. The principal problem lies in the middle and it is set within the duty suspension and movement system we have which allows, nay requires, that spirits be moved, sold and re-sold many times, crossing borders within the European Union, without the duty actually having been paid and requires a system of physical and manual documentation which is specified in a way which does not allow us properly to identify some of these movements and gives considerable scope for the fraudsters to falsify the documents.

Q388 Chairman: In conclusion, will there be any exemptions of the strip stamp, for example for alcohol below a certain strength, for firms employing fewer than a certain number of people or on bottles which are less than 70cl?

John Healey: We are looking at exempting from this requirement certain types of spirit and spirit based drink. We are looking at exempting certain sizes of bottles. We are not looking at exempting a certain size of company and this will be clear in the draft clauses of the Finance Bill which I would encourage the Committee to examine. This is a very legitimate and important area of debate which I know we are going to have in this House as the legislation passes through both in the chamber and in committee.

Chairman: Minister, may I thank you and Mr Pearce very much indeed for coming along today and for being frank and full with your answers to the Committee. I can assure you that this will be extremely helpful to us when we come to making our report. Once again, thank you very much for your attendance.

APPENDIX 1

Letter to Mr Alistair Carmichael MP from Spectroscopic & Analytical Developments Ltd

Dear Mr Carmichael

DETECTION OF COUNTERFEIT WHISKY

As a speaker in the recent debate on the proposal by the Treasury that, in order to overcome loss of revenue caused by the sale of untaxed counterfeit spirits all bottles sold in the UK should carry a stamp, we are sure you will be interested Diageo's new whisky authenticator—a technically advanced, inexpensive, solution to the detection of counterfeit product, which could avoid the use of stamps.

Diageo is the first company to adopt the new testing kit. They developed the technique used and then worked with UK company sAd to make a portable, easy to use instrument. Diageo announced the breakthrough on Thursday 12th February.

The authenticator is designed to be both portable and easy to use, allowing Customs and Excise, Trading Standards and other policing bodies to check suspect product on the spot as soon as they are discovered and to have the results of the test in under a minute. Before now tests have been conducted in a lab and results have taken a week or so for results to come through.

This groundbreaking, technically advanced new product has been developed in the UK. As a patented British product the authenticator has world-wide potential not just in anti counterfeiting of whisky, but—when adapted—for identifying other counterfeit spirits and for measuring details such as pollution in water and wine quality.

The instrument stores the “fingerprints” of the genuine products, to which the measurement of the suspect sample, is compared. A green light indicates genuine product and a red light something else.

In addition to identifying counterfeit products the instrument can also detect the presence of extra water in a genuine product, a source of lost revenue the Treasury does not appear to have considered.

Attached is a Press Release giving more details¹.

Dr John P Ferguson
Director

12 February 2004

APPENDIX 2

Letter to the Committee from CBI Scotland

INQUIRY INTO THE POSSIBLE INTRODUCTION OF TAX STAMPS ON SCOTCH WHISKY AND OTHER SPIRIT DRINKS

I am writing to contribute the views of CBI Scotland to the Inquiry into tax stamps, which we welcome. CBI Scotland is the largest and most broadly based Scottish business organisation, representing the views of more than 26,000 businesses of all sizes and sectors.

We would like to support the concerns raised by the Scotch Whisky Association (SWA) in their written evidence. While all of us want to see alcohol fraud tackled effectively, this must be done in ways which are effective and well-targeted while minimising compliance burdens on the industry. As the SWA evidence makes clear, there is much doubt as to whether the tax stamps proposals meet these criteria.

The point about minimising compliance burden is especially important in the wider context of the cost pressures on Scottish manufacturers. Such firms tend to face higher business rates and water charges than firms elsewhere in the UK, and the CBI's latest Scottish Industrial Trends survey while showing a welcome improvement in orders, also shows relentless erosion of margins as costs creep up faster than selling prices. An unnecessarily burdensome and possibly less than effective anti-fraud proposal for the spirits industry is not what is needed at such a time.

We note that the SWA has submitted to the Committee details of various alternative anti-fraud proposals. Other CBI members have been involved in the discussions around some of these alternatives, and we hope that the Committee will look carefully at them.

Please let me know if we can be of any further assistance.

Matthew Farrow
Head of Policy

1 March 2004

¹ Not published.

APPENDIX 3

Memorandum submitted by the Scottish Trades Union Congress

INTRODUCTION

1. The STUC represents some six hundred and 30,000 workers across Scotland, the members of our affiliated trade unions.
2. We speak for trade union members in and out of work, in the community and in the workplace, and our affiliates have interests in all sectors of the economy.

KEY MESSAGES

3. The STUC believes that the introduction of tax stamps will:
 - Provide an unwelcome barrier to productivity and competitiveness in the Scotch whisky industry;
 - Increase job insecurity among workers in the industry, many of whom live and work in fragile rural communities which offer little prospect of alternative employment;
 - Potentially upset the generally constructive industrial relations currently enjoyed within the industry; and,
 - Have little impact on fraud.

IMPORTANCE TO THE SCOTTISH ECONOMY

4. Scotch whisky is Scotland's third largest export and, unlike some other important manufacturing sectors, draws most of its inputs from local suppliers. Over 10,000 people are directly employed in Scotch whisky production with some 41,000 jobs in Scotland (and 65,000 jobs across the UK) indirectly supported by Scotch whisky production.
5. When considering the importance of these jobs to the Scottish economy it must be borne in mind that many are embedded in our economically fragile rural communities. Experience in the textiles, fishing and oil industries tells us that jobs lost in the rural economy can be difficult to replace. Therefore, any new initiative that threatens to disproportionately affect the rural economy must be treated with great caution.
6. It is vitally important that the Scotch whisky industry remains competitive to support Scottish jobs and the wider, especially rural, economy. It is a concern that in the increasingly competitive global market extra costs may lead employers, rightly or wrongly, to move their bottling operations to low labour cost economies overseas.

TAX STAMPS

7. The STUC recognises, as does the industry itself, that there is a problem with the evasion of duty on spirits. This fraud affects trade union members as;
 - *workers* through the negative impact on the legitimate trade; and,
 - *citizens* through the loss of government revenue which could be spent on providing important public services.
8. However, we believe that the introduction of tax stamps will place an unnecessary burden on the industry, which is bound to adversely affect productivity and competitiveness. We are also not convinced that tax stamps will tackle fraud effectively.
9. The whisky industry currently benefits from employee relations which are generally positive. We are aware that our affiliates the GMB and Amicus have a number of successful partnership agreements with employers in the whisky industry.
10. We are therefore particularly concerned that the introduction of tax stamps could adversely affect this positive situation. The stamps are easily concealed and very valuable, each worth £5.48 in excise duty for a 70cl bottle of whisky. While we do not believe that our members would ever jeopardise their jobs by indulging in theft we must accept that employers will have to implement new security procedures that may not be easily absorbed into workplaces where trust and respect between employer and workforce have been the norm. An unhappy workplace is a less productive workplace.

CONCLUSION

11. The STUC believes that a modern open economy like Scotland can only prosper if it is effectively regulated and if employers are prepared to shoulder costs that should properly fall on them rather than the general taxpayer. Therefore, we often disagree with employer representative bodies over what constitutes a "burden" on business.

12. However, in this instance we do agree that the introduction of tax stamps is indeed an unnecessary burden on the Scotch whisky industry. The potential consequences for the industry, its employees and the Scottish economy hugely outweigh any discernible benefits.

13. We would encourage the Committee to look at the alternative proposals submitted by the Scotch Whisky Association and lobby the Treasury to consider methods of reducing fraud which do not involve the introduction of tax stamps.

March 2004

APPENDIX 4

Memorandum from The Scottish Council for Development and Industry

1. The Scottish Council for Development and Industry (SCDI) is an independent economic development organisation that strengthens Scotland's economy through the formulation and promotion of innovative public policies to encourage sustainable economic prosperity. Its members are drawn from businesses, local authorities, trades unions, educational institutions and the voluntary sector.

2. SCDI welcomes the Committee's decision to hold an inquiry into the proposal, as announced in the December 2003 Pre-Budget Report, "to make preparations for the implementation from early 2006 of the Roques report recommendation to introduce tax stamps for spirits." It is an issue that SCDI has previously expressed concerns to HM Treasury (March 2002) due to the adverse impact it will have on the Scotch Whisky industry. SCDI welcomes the opportunity to reiterate its views to the Committee.

3. SCDI's first concern is in regard to trade. Whisky accounted for £2.285 billion (14.5%) of Scotland's £15.725 billion of manufactured exports in 2002. Ease of access to export markets is of vital importance for the success of this Scottish product. The Whisky industry and the UK Government have, in the past, successfully argued against the introduction of tax stamps in international markets such as Norway on the grounds that they are a barrier to trade. As stated by the Department of Trade and Industry in 1997, tax stamps "conflict with the free movement of goods" and are contrary to the goal of establishing a single market throughout the EU. Were the UK to introduce tax stamps our position would be completely reversed and other governments may also be encouraged to introduce them to the disadvantage of the export trade of the industry.

4. SCDI is also concerned that there is a lack of evidence over the effectiveness of tax stamps in combating fraud. Indeed, as far as SCDI is aware, several countries, including the USA, have abolished their use due to a lack of effectiveness and others have investigated their use only to reject them.

5. On a micro level, the cost of introducing these tax stamps would have a major impact on whisky producers, particularly small distillers. Significant investment in new specialised machinery would be required which would impact negatively on established efficient production processes.

6. The cash flow of companies would also be seriously affected. Stamps would be purchased and duty paid prior to the product being bottled in contrast to the present system where duty is paid when the product is distributed to the retailer. Inevitably, a significant time lag will occur between paying duty via a tax stamp and the recovery of that duty once the product has been purchased, adversely affecting cash flow.

7. Any added cost to the distillers will, inevitably, be reflected in the price of Whisky to the customer. Due to the nature of demand for Whisky and other spirits, which is very price sensitive, ie when price increases, demand falls by a greater proportion, revenue to the Exchequer could be affected by the introduction of tax stamps. This will dilute the main reason for tackling alcohol fraud, namely the loss of taxation revenue.

8. Finally, in the Pre-Budget Report, it states that the Government, "will also consider any new proposals the spirits industry wishes to put forward in the coming months for alternative measures that would be as effective in tackling spirits fraud as tax stamps". SCDI understands that the Whisky industry has brought forward a series of proposals that would be significantly more effective than strip stamps, both in terms of revenue gained and fraud combated. These measures include a revision to the system of guarantees used when moving and warehousing spirits and improved partnership working between the spirits industry and Customs and Excise using the existing Joint Spirits Fraud Task Force (JSFTF).

9. In fact it has been initiatives such as the JSFTF, established two years ago as an alternative to the introduction of tax stamps at that time, that have been successfully tackling alcohol fraud. As a result, SCDI notes that there is some dispute as to the extent of the revenue loss due to fraud that tax stamps are intended to combat. Government estimates are reported to be overstated. Before strip stamps are introduced, estimates of the impact of fraud must be as accurate as possible, there should be agreement about the extent

of the problem to ensure that the case for introduction is valid and the Government must state why it is disregarding the Whisky industry's positive proposals to address the issue of fraud. Currently, this is not the case.

10. For these reasons SCDI is against the introduction of tax stamping on spirits. I trust these views will be taken into consideration.

Ian D Duff
Chief Economist

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