The Impact of Plain Packaging on Retailers: An unlawful and disproportionate burden

Summary

On 12 February 2015, alongside a report on last year’s consultation on the introduction of standardised packaging, the Department of Health (“DoH”), published a Final Regulatory Impact Assessment (the “Final IA”). The Final IA acknowledges that the introduction of standardised packaging for tobacco products in the UK could have a number of unintended consequences for UK retailers, including:

- a cost to retailers of at least £20 million over ten years as a result of an increase in illicit trade and cross border shopping;
- a loss of retailer profits of at least £90 million over ten years as a result of consumers’ down-trading from premium brands; and
- a loss of retailer profit of at least £0.5 million associated with a temporary increase transaction times.

Despite acknowledging these risks, the Final IA disregards the direct empirical evidence from Australia, which shows that to date plain packaging is failing to achieve its policy objectives and that the above consequences are indeed being realised. The DoH’s stated rationale for rejecting such evidence is that the impacts of plain packaging on the Australian market cannot be disentangled from other confounding factors. Instead the Final IA relies on subjective and indirect evidence in an attempt to justify the introduction of plain packaging. The evidence in the Final IA comes from a single study, the authors of which have admitted bias.

In preferring such evidence, the Secretary of State has acted irrationally – improperly disregarding relevant considerations and taking into account irrelevant considerations and/or attributing improper weight to those considerations properly taken into account. Accordingly, any decision by the Secretary of State to proceed with standardised packaging regulations would be unlawful.

Increase in illicit trade and cross border shopping

Plain packaging will exacerbate an already serious illicit trade problem in the UK; HMRC estimates that in 2013-14 up to 14 per cent of cigarettes and 43 per cent of hand-rolled tobacco consumed in the UK were illicit. This represents an estimated loss of revenue of up to £2.9 billion, an increase of £500 million from 2011-12. In addition, cross-border shopping is currently estimated by HMRC to lead to a loss of revenue (of both VAT and tobacco excise duties) of £600 million. Both illicit trade and cross border shopping therefore already deprive retailers of significant profits which would otherwise be generated through the sale of UK duty paid tobacco products.

The evidence from Australia indicates that illicit tobacco consumption increased following the introduction of plain packaging, from 11.8 per cent in 2012 to 13.9 per cent in 2013, to reach a seven year high.

The Department of Health concedes in the Final IA that the introduction of plain packaging may result in a reduction in retailers’ profits as a result of an increase in illicit trade and cross border shopping, which it estimates at a Net Present Value (NPV) of around £20 million. While we do not agree with this
quantification as we believe it to be understated, we consider that a significant reduction in retailers’ profits is likely.

Similarly, in its assessment on the potential impact of plain packaging on the UK illicit tobacco market, HMRC acknowledges the risk that the introduction of plain packaging will lead to an increase in the market for “illicit whites” and counterfeited tobacco products.

- HMRC considers it “highly likely that the introduction of standardised packaging will provide a suitable environment in which illicit white cigarettes will continue to grow in the UK illicit market. Standardised packaging is likely to further push consumers to be driven mainly by price. With branding all but removed, smokers, already motivated largely by price, may be more open to trying unfamiliar brands and driven towards the illicit market.”

- HMRC concedes that “Futures analysis suggests it is possible that the introduction of standardised packaging will lead to increased attempts to infiltrate counterfeit product into the lower-end of the retail supply chain.”

HMRC seeks to assert that these risks are mitigated by active enforcement measures against illicit trade, but the statistics set out above belie that this problem is currently under control.

Plain packaging will only make the scale of the problem significantly worse, which will:

- further undermine the intended health objectives of the measure by driving more people to cheaper, illegal tobacco products (encouraging increased consumption) which are potentially more dangerous to consumers’ health due to the lack of safeguards surrounding their production;

- deprive Government of legitimate revenues from the sale of UK duty paid tobacco products;

- deprive retailers of legitimate profits from the sale of UK duty paid tobacco products, which will be lost to the sellers of illicit whites and to neighbourhood crime gangs who deal in contraband tobacco; and

- deprive small retailers of legitimate turnover in respect of other categories of products sold in their shops, in respect of which they will lose sales when customers move away from outlets selling legitimate products to those selling illicit products.

Codentify

In addition, if adopted the Standardised Packaging for Tobacco Products Regulations 2015 (the “Regulations”) would, as currently drafted, preclude the use of an important tool in the fight against illicit trade in tobacco. Specifically, the NFRN understands that a number of UK tobacco manufacturers are currently working with HMRC to roll out a pilot product authentication system. Manufacturers are voluntarily printing an alphanumeric code on the bottom of each pack and RYO pouch, that HMRC officers can then check via an SMS system to let them know whether a pack is counterfeit or not. Packs featuring the code are already in market and HMRC officials have received training on how to authenticate the products. This pilot is an initiative supported by HMRC.

However, under the Regulations as currently drafted, it would not be permissible to print the alphanumeric code on the packs. Under the Regulations, nothing can be included on packs that aren’t specified by the
Regulations. The Regulations state that they do not supersede any other legal requirements, that is, a feature required by ‘any other enactment’ is permitted under standardised packaging.

Because printing the authentication code is entirely voluntary, and flexibility to provide for it will not be permitted once plain packaging is introduced, a key component in the fight against illicit tobacco trading will be lost. This represents a serious flaw with the Regulations that must be amended before any vote can take place.

**Increased costs to retailers**

The Department of Health acknowledges in its Final IA that “standardised packaging reduces the ability of tobacco manufacturing firms to sustain sales of higher priced products relying on brand characteristics.”

The consequence of this is that retailers will also suffer significant increased costs attributable to reduced sales of premium brands upon the introduction of plain packaging. The loss of profits is estimated by the Department of Health at an NPV of around £90 million over ten years. While this quantification is understated in our view, we agree that a very significant reduction in retailers’ profits is likely.

**Disproportionate burden on retailers**

There will be a number of potential direct cost impacts on retailers arising from the introduction of plain packaging, for example, in relation to inventory management, transaction efficiency, security costs, and the potential for channel shift to larger retailers, disadvantaging smaller independent stores.

Plain packaging will increase transaction times while retailers attempt to dispense retail packs that all look the same. In the UK, where a retail display ban is already in place, this process will be even more complex and time-consuming for the retailer. This increased time spent is likely to translate into the need for additional employees or loss of productive time, loss of sales and customer dissatisfaction. The Department of Health acknowledges the risk of such an impact on retailers in its Regulatory Impact Assessment although we dispute its assessment that the monetary impact of this increased logistical burden is minimal.

Plain packaging could also significantly increase retailers’ vulnerability to different types of crime (shop lifting, robbery, injury, etc.) as they will be more distracted while retailing tobacco products.

**Plain packaging is unlawful**

The UK Government has acknowledged that it is unable to derive compelling evidence as to the direct effects of plain packaging in Australia due to “confounding” factors (such as existing trends of decreasing smoking prevalence and increasing prices). It is clear, however, that while the data from Australia shows no clear link between plain packaging and a reduction in smoking, it does show an increase in illicit trade since the introduction of the measure. Further, as stated above,

- HMRC acknowledges the risk of increase in the market for illicit whites and counterfeit tobacco products;
- the Department of Health acknowledges that it is likely that retailer profits will decrease as a result of an increase in illicit trade, downtrading, intensified price competition and increased transaction times; and
the Regulations will preclude the use of a voluntary supply chain authentication code - an important tool in the fight against illicit trade.

As such, there are clear risks and costs associated with the measure but no evidence of benefits.

In addition, the UK needs Article 24 of the new Tobacco Products Directive (“TPD”) in order to introduce standardised packaging. However, the NFRN understand that the validity and interpretation of this Article is currently the subject of a legal challenge in the Court of Justice of the European Union. At the very least, it would seem appropriate to await a decision in those proceedings before proceeding with standardised packaging in the UK.

Similarly, if - as the NFRN understands is likely - a separate legal challenge is brought against the Regulations, there is a very real risk that any such challenge would not be determined before standardised packaging falls to be applied in the UK (i.e. from the 20 May 2016). At the same time, the impacts of plain packaging on the market identified by the Department of Health and HMRC, including the risks of down trading, intensified price competition, and increased illicit or NDP trade, could potentially be irreversible and, once started, unstoppable. Accordingly, by proceeding with the Regulations at this stage, the Government is exposing retailers to the risk of incurring the full costs and loss of profits that it has identified, costs and loss of profits that would be irrecoverable even if the Regulations are ultimately deemed to be unlawful, and branded packs allowed back onto the market.

Accordingly, any decision to proceed with plain packaging at this stage is unlawful on the basis that it is irrational and would pose a disproportionate and potentially irreversible burden on retailers.