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Smuggling of cigarettes in Malaysia: Analysis, Opinion and Solutions for its management and eradication

Advance Global Synergy Sdn Bhd

Smuggling is a global phenomenon and Malaysia is not excluded from it. In recent years, the tobacco industry followed by other stakeholders have highlighted that the impact and consequences of tobacco smuggling has reached critical levels. The smuggling of cheap cigarettes into Malaysia has been growing exponentially since the start of this decade and has caused deep-seated concerns...

Chapter 1 ...Preamble

1. The legal tobacco industry in Malaysia, comprising British American Tobacco ("BAT"), Japan Tobacco International ("JTI") and Philip Morris International ("PMI") have lamented about the exponential increase in levels of smuggled cigarettes in the domestic marketplace, dramatically compressing legal market share to less than 50% over the past decade.

1.1. BAT is still the leader in terms of market share (53%), followed by JTI (21%) and finally PMI (19%). The total consumption for legal cigarettes is currently **nine (9) billion sticks per annum**¹, relative to a **national smoking incidence of 23%**.

1.1.1. Malaysia is ranked 71st globally in per capita cigarette consumption, with an average of 646 cigarettes smoked per adult annually.

1.1.2. The National Health Morbidity Survey 2015 revealed that about five million or 22.8 per cent of the Malaysian population aged 15 and above were smokers.

1.2. The much smaller local manufacturers, contributing to less than 7% of the legal tobacco industry in terms of volume, are not part of the now-disbanded Confederation of Malaysian Tobacco Manufacturers ("CMTM") and are precluded from this discourse, e.g. Aneka Karya Jaya Sdn Bhd and Global Tobacco Manufacturing Sdn Bhd.

1.3. The Government has ceased the issuance of tobacco manufacturing licenses since 2001 and none of the "Big Three" tobacco players operate domestic supply factories at the moment – all having been shut-down in the last two years.

2. The Illicit Cigarettes Survey ("ICS") – a litter survey sponsored by the tobacco industry – is conducted three (3) times per annum, has recently declared that the level of smuggled cigarettes has reached yet another all-time high i.e. **55.6% for full-year 2017**.

2.1. "Illicit cigarettes" as defined under the ICS, are basically cigarettes that are sold below the minimum price requirement and categorized as follows: -

¹ This 9 billion sticks is inclusive of the local duty free market. If excluding the local DF market, the local domestic paid market volume is approximately 7.3 billion sticks only.

- 2.1.1. Cheap whites
- 2.1.2. Cheap kretek (clove cigarettes)
- 2.1.3. Counterfeited brands
- 2.1.4. Extremely low priced cigarettes
- 2.1.5. Packs with fake customs stickers

2.2. Since 2007, the volume of counterfeited brands in the domestic market has reduced to insignificant levels, although the threat still exists in very low quantities in certain urban areas.

3. Royal Malaysia Customs (“RMC”) has stated that the volume of seizures related to cigarettes smuggling has increased year-on-year, and in 2017 they seized cigarettes with corresponding tax value of almost **RM 1 billion**, and that they have reviewed importation procedures to reduce the risk of smuggling, including “manifest controls” and suspending the operating license of freight forwarders involved in smuggling activities.

3.1. The [Customs Act 1967](#) was amended towards end of 2017 to penalize anyone found selling smuggled cigarettes, with nearly 100 individuals already prosecuted and fined for the offence.

3.2. RMC reportedly seized contraband cigarettes amounting to RM 1 billion in taxes in 2017 and is expecting to perform even better in 2018. However the question that begs to be asked is: despite such voluminous seizures by RMC, why is the level of smuggled cigarettes still increasing? We believe that is due to the various entry points exploited by the syndicates and they may switch mode and point of entry conveniently to ensure the supply chain is stable. Another hypothesis is that the seizures are nothing more than “eyewash” for the relevant authorities and the public, akin to the tip of the iceberg only.

4. If the current trend is not reversed, the level of illicit is expected to continue rising and may hit 60% or more by year-end, thus depriving the legal tobacco industry of roughly **RM 2 billion in net profit** and the government of nearly **RM 6 billion in derivable excise and tax revenue** (not taking into account direct and indirect taxes from legal players).

Chapter 2 ...Objectives

1. The purpose of this document is mainly to analyze the situation and circumstances pertaining to smuggling in general, and cigarettes smuggling in particular.
2. Through this comprehensive analysis, we intend to put forward our opinions and also recommendations towards minimizing the impact of smuggling upon legal industries in Malaysia, hopefully providing the required insight and professional opinion that will contribute towards the preventive and enforcement framework for the authorities and government.
3. This document is intended to be a white paper for the benefit of all stakeholders, regulators and the public at large.

Chapter 3 ...Limitations

1. The primary limitation of this document is the sensitive nature of the subject and its legal ramifications upon the industry and government in terms of enforcement measures.
2. However, the information contained herein to the best of our knowledge is not derived from any classified information but solely from open sources that are available to the public at large.
3. The ICS is an industry report funded and published by the tobacco industry and is not made available for public consumption, references can only be made to it via news articles published in print and online.
4. This white paper is mainly based upon the smuggling of cigarettes due to the fact that it has been publicized and widely commented upon as compared to any other type of smuggling activity currently taking place in the country, with the exception of narcotics and human trafficking.

Chapter 4 ...The Authors

1. [Advance Global Synergy Sdn Bhd](#) ("AGS") was founded in December 2017 and its business is consultation and advisory for industries that require effective regulatory and enforcement engagement, particularly industries that are impacted through smuggling and intellectual property rights ("IPR") violations. Our mission is to deliver sustainable solutions that will drive growth and/or suppress costs for our clients, thereby playing an active role in their business and industry.

2. The founders of AGS are: -

2.1. Azlan Ibrahim.

A trade marketing specialist, Azlan led the marketing team at Rothmans of Pall Mall Malaysia Bhd. ("RPM") before its merger with BAT to become what is now British American Tobacco (Malaysia) Bhd. Thereafter, Azlan spearheaded the battle against illicit trade, managing and implementing strategic action plans and focused engagement to stem the influx of smuggled cigarettes into the country. Through the years, he has cemented his relationship with the RMC and the Ministry of Domestic Trade, Consumerism and Cooperatives ("MDTCC") Enforcement division to the point of being their trusted advisor on matters concerning the smuggling of cigarettes. After retiring from BAT in 2014, Azlan continues to provide specialist services in engaging government stakeholders, as his skill and experience in the subject matter is to-date unparalleled and very much sought after, and he has been involved with the tobacco industry and enforcement authorities for the better part of three decades.

2.2. Mohamad Sheik Mana.

Sheik, as he's fondly known, is a retired police officer holding the rank of Deputy Superintendent ("DSP"). Even while in the police force, Sheik headed the commercial crimes investigation unit within the Criminal Investigation Department, and is well known for his involvement in many high profile cases as the investigating officer. After a stint as the head of security for Hong Leong Bank Berhad, he joined BAT Malaysia in the similar capacity and went on to be the regional head of security for BAT, managing its security risks for South East Asia. Sheik retired from BAT in 20... but went on to set-up his own security guarding firm and a risk consultancy firm. He has been involved in various projects in and out of Malaysia, advising on security risks and drawing up management systems to assist corporations enhance the service delivery and performance of its security resources and assets.

2.3. Riduan Devaruban.

Riduan is yet another product of quality police training, having resigned from the Royal Malaysia Police ("RMP") in 2005

with a law degree in hand, he joined Shell Malaysia Trading Sdn Bhd as a downstream security risk advisor. Two years later he joined BAT Malaysia and worked directly with Azlan and Sheik in designing, deploying and managing the intelligence support services that would be instrumental to RMC and other enforcement agencies in tackling the influx of smuggled cigarettes. Riduan has the unique experience of dealing with cigarettes smuggling from within the industry as the manager for the anti-illicit trade agenda, and also from outside as a consultant and service provider. After leaving BAT in 2013, Riduan continued to grow his specialist skillset by being a consultant to the tobacco and beer industries, and even for the telecommunications industry at one point. He continues to be a point of reference to RMC, RMP, MDTCC and even the Malaysian Anti-Corruption Commission ("MACC") and occasionally provides consultation to investment managers and private equity funds on current developments and future of the tobacco industry in Malaysia.

Chapter 5 ...Abstract

Smuggling is a global phenomenon and Malaysia is not excluded from it. In recent years, the tobacco industry followed by other stakeholders have highlighted that the impact and consequences of tobacco smuggling has reached critical levels. The smuggling of cheap cigarettes into Malaysia has been growing exponentially since the start of this decade and has caused deep-seated concerns within the community at large, mainly due to the easy availability of cheap smuggled cigarettes and its extremely cheap price, which are seducing youths and even non-smokers to pick up the habit. Though the tobacco industry has repeatedly stated that there are severe repercussions to the unprecedented level of smuggled cheap cigarettes – per their annual market survey – the actual issue here is the impact of smuggled cigarettes (and other commodities) upon the nation's long-term development plan and the cost burden that the Government of the day will be saddled with in order to alleviate or eradicate the issue. Several other factors further aggravate the circumstances, with corruption being chief amongst them all, and no less than a strategically coordinated multi-prong approach will suffice given the state of affairs as it is today. Though there is a light at the end of the tunnel, it is quickly fading, and time is always of the essence if an action plan is to be formulated and implemented successfully. The true victims in the scenario of cigarettes smuggling has and will always be the people of Malaysia, with the

Government of the day left to deal with the residual issues of public health and its impact on national development.

Chapter 6 ...The Current State of Affairs

1. The smuggling of cigarettes is costing the tobacco industry in Malaysia in excess of **RM 2 billion per annum** from lost revenue and even more in reputational impact. The volume share for smuggled cigarettes is now **55.6%** based on the latest ICS report released by the industry in 2017, which translates into approximately **22% compound annual growth rate** ("CAGR") over the last decade.

Illegal cigarettes are the undisputed market leader in Malaysia (one out of two packs sold is illegal)

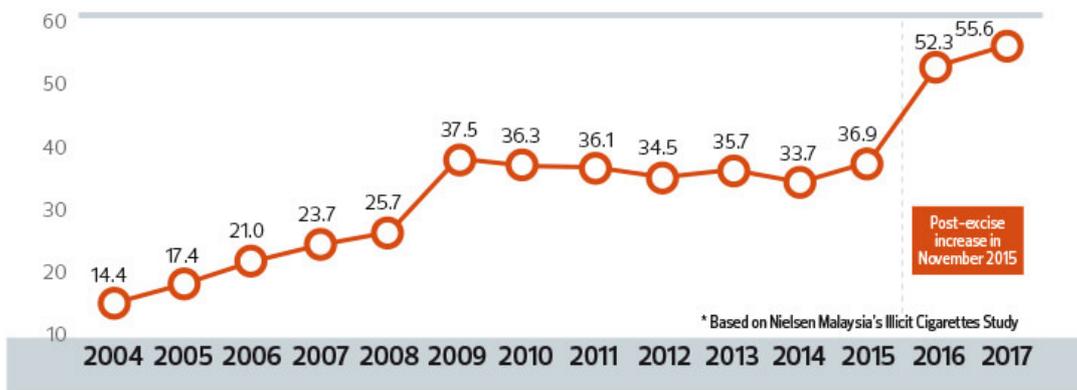


Chart 1 – credit to The Edge™ Markets, published on 24 April 2018.

2. Since 2007, the tobacco industry has attempted to reverse the trend and reduce the volume of smuggled cigarettes in the market through various initiatives, tackling the issue from all possible angles along its supply chain from importation through to distribution to the retailer. It is important to note that despite millions of Ringgit spent and thousands of man-hours invested in driving the anti-illicit trade agenda, the availability of smuggled cigarettes continues to grow at exponential rate and its pricing has remained stable over the last decade.
3. RMC is the primary enforcement agency with the purview over smuggling as in essence it relates to the avoidance of duty and tax that is due upon its importation. Let alone the cost of resources to execute the anti-smuggling measures undertaken by RMC, the loss of derivable tax revenue due to smuggling of cigarettes runs into billions of Ringgit and is steeply declining year on year. Despite the reported volume of seizures increasing annually, the industry continues to record declining sales and

cheap smuggled cigarettes are becoming even more accessible to consumers, and more worrying is its attraction to young adults.

- 3.1. The MDTCC Enforcement division also has a purview over the sale of smuggled cigarettes, by way of the [Price Control and Anti-Profitteering Act 2011](#) ("PCAPA 2011"), but their main concern has always been the proliferation of illicit products among the consumer population rather than the impact of the same upon the economy.
 - 3.2. The Ministry of Health ("MOH") also conducts regular enforcement activities via its Non-Communicable Disease Unit to basically generate awareness of smoking and its consequences, by way of enforcing non-smoking areas, against the sale of non-approved products and mainly non-compliance to the Control of Tobacco Products Regulations 2004 ("CTPR").
 - 3.3. The Border Security Agency or *Agensi Keselamatan Sempadan* ("AKSEM") under the Home Affairs Ministry and the Marine Police division have also been lending critical assistance to RMC in dealing with direct smuggling across the Thailand – Malaysia border and along the Straits of Malacca respectively.
4. The Government of Malaysia is a signatory to the [Framework Convention for Tobacco Control](#) ("FCTC") that is enforced through the World Health Organization ("WHO") and the government is required to consistently implement measures to reduce smoking incidence among its population, including raising tax to 65% of the pack price or more – currently tax is at **52% of the pack price** (~RM 8 per pack) and the minimum price for a pack of 20 sticks is RM 10.
 - 4.1. This ratification of the FCTC has been a stumbling block to any effort by the tobacco industry as the Ministry of Health ("MOH") religiously clings to its doctrine and considers any action in support of the tobacco industry as contrary to the spirit of the FCTC – a point which is being argued till this date by the tobacco industry as being restrictive and near-sighted.

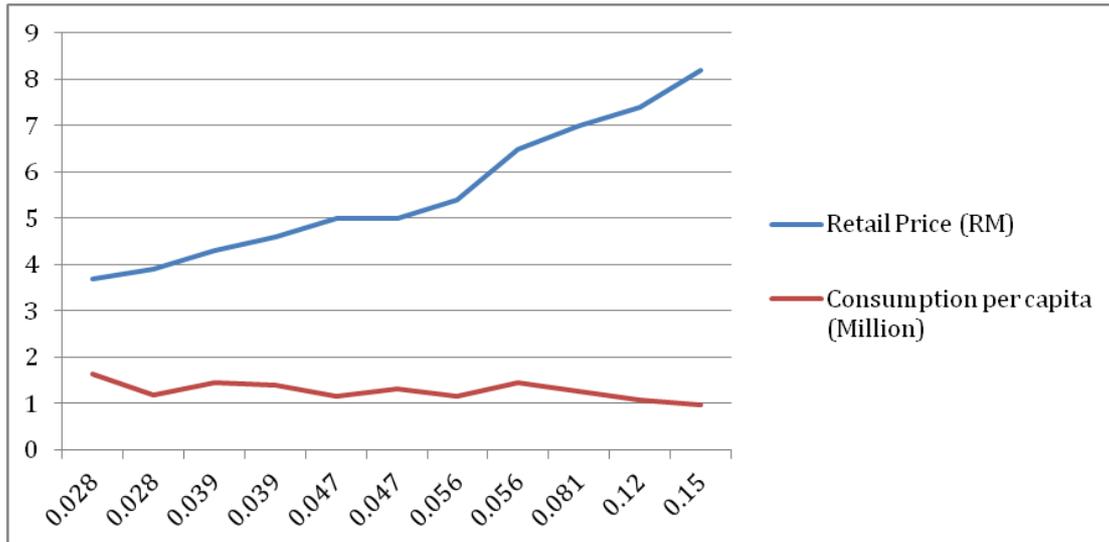


Chart 2 – correlation between per-pack retail pricing vs. consumption; revealing that price has little impact on cigarettes consumption. Credit – www.taknak.myhealth.gov.my

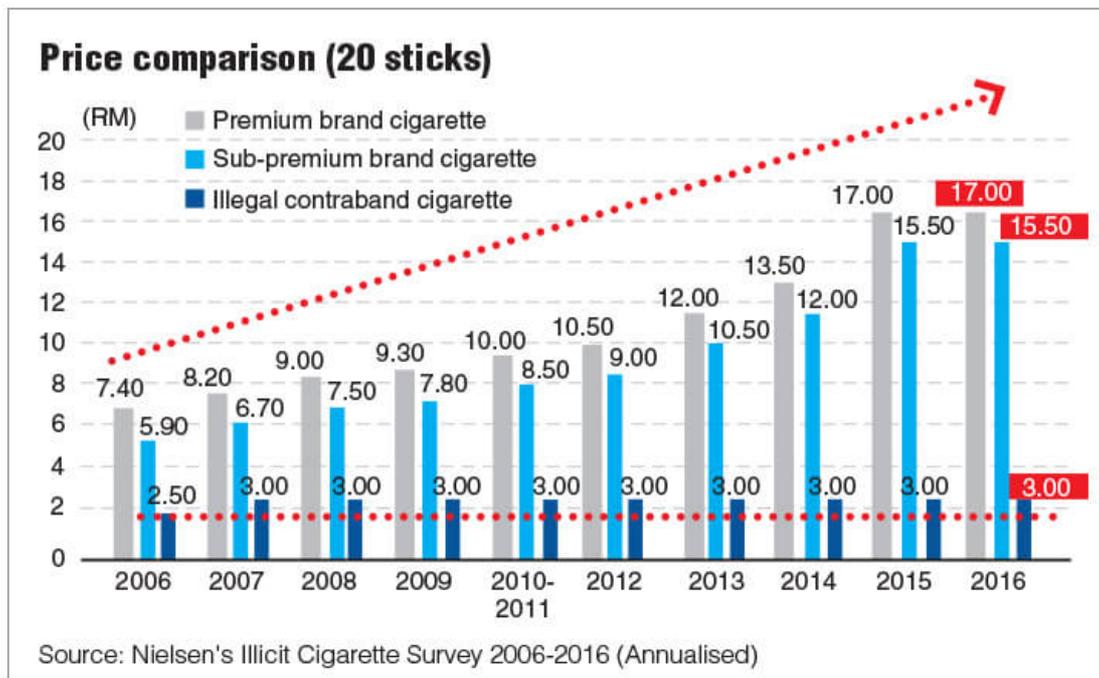


Chart 3 – cigarette price comparison by segment. Published in The Edge™ Financial Daily on 11th May 2017. An updated version of this chart should be available in the 2017 ICS report, where the ceiling price for “illegal contraband cigarettes” would be RM 5.

Chapter 7 ... The mechanics of smuggling in Malaysia

Preamble

1. Malaysia has a total coastline of 4,675 km; 2,068 km in the Peninsular of Malaysia and 2,607 km along Sabah and Sarawak in East Malaysia or Borneo.
2. There are currently seven (7) international-status ports in Malaysia i.e.

- 2.1. Port Klang, Selangor – consisting of Northport and Westport, which are privately managed through concession agreements.
 - 2.2. Johor Port, Johor Bahru, Johor.
 - 2.3. Port of Tanjung Pelepas, Johor – also a privately managed port.
 - 2.4. Kuantan Port, Pahang.
 - 2.5. Penang Port, Butterworth, Penang.
 - 2.6. Bintulu Port, Sarawak.
 - 2.7. Kemaman Port, Terengganu.
 - 2.8. Nilai Land Port, Negeri Sembilan – mainly to facilitate air cargo shipments from the Kuala Lumpur International Airport (“KLIA”).
3. In addition, there are also nine (9) land border checkpoints that are operated and enforced by the authorities in Malaysia i.e.
- 3.1. Padang Besar, Perlis.
 - 3.2. Wang Kelian, Perlis.
 - 3.3. Bukit Kayu Hitam, Kedah.
 - 3.4. Duriang Burung, Kedah.
 - 3.5. Pengkalan Hulu, Perak.
 - 3.6. Bukit Bunga, Kelantan.
 - 3.7. Rantau Panjang, Kelantan.
 - 3.8. Johor Bahru – Singapore Causeway.
 - 3.9. Malaysia – Singapore Secondlink Expressway.
4. The tax structure for the importation of tobacco and sale of cigarettes is currently as follows: -
- 4.1. Any importation of cigarettes will attract import duty and excise at RM 0.20 per stick and RM 0.40 per stick respectively upon submission of declaration documents.
 - 4.2. In addition, the importer must also pay GST at 6%. (Previously sales tax at 10%.)
 - 4.3. An example of how tax and excise on tobacco and cigarettes are computed:

$$\begin{aligned} \text{Declared import volume} &= 10,000 \text{ sticks (1 m-c or 500 packs)} \\ \text{Import Duty (RM 0.20/stick)} &= \text{RM } 2,000 \\ \text{Excise (RM 0.40/stick)} &= \text{RM } 4,000 \\ \text{GST (6\%)} &= [\text{RM } 6,000 \times 6\%] = \text{RM } 360 \\ \text{Total tax and excise} &= \text{RM } 6,360 \text{ or } \mathbf{\text{RM } 12.70 \text{ per pack}} \end{aligned}$$

4.4. As for the domestic tobacco players, who are currently importing their cigarettes from neighboring countries in South East Asia, they qualify for a special tariff under the ASEAN free trade treaty i.e.

$$\text{Tax} = \text{Import Duty (5\% CIF rate)} + \text{Excise (RM 0.40/stick)} + \text{GST (6\%)} \sim \text{RM 8.60 per pack of 20 sticks.}$$

4.5. Note that the time of publication, GST has been abolished by the new *Pakatan Harapan* government as of 1st June 2018, and will be replaced by a revised Sales & Services Tax regime that will be implemented on 1st September 2018 onwards.

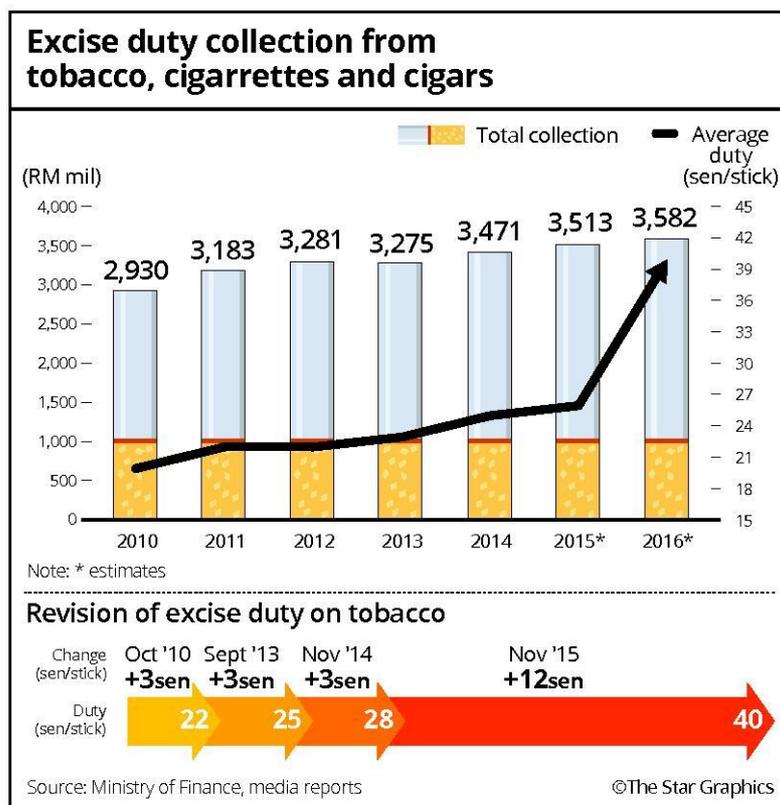


Chart 4 – credit to The Star Online, published on 5th November 2015. Note that in 2016, the steep increase in the excise rate made up for the shortfall in volume from the legal industry, thus the marginal year-on-year increase of tax collection.

5. There are namely two (2) types of smuggling i.e.

5.1. Direct smuggling – whereby the contraband is brought over the borders without any declaration whatsoever and is usually facilitated through bribery. Modes of smuggling include fast-boats and land-based modes of transport, some of which have been fitted with hidden compartments.

5.2. Indirect smuggling – at port level mainly, whereby the importer attempts to defraud the government by submitting false declarations of the shipment, thereby evading excise and tax. This is the most commonly used mode of smuggling due to the high volumes that can be smuggled into the country per instance, when compared to the significantly lower volume via boat or truck (maximum 100 – 200m-c per trip). Indirect smuggling is also less risky as the details of the declaration are fictitious and could lead investigators on a “wild goose chase”.

5.3. It is estimated that the ratio of indirect vs. direct smuggling is currently **60:40**, i.e. in favor of indirect smuggling.

6. All of the aforementioned ports and land border checkpoints are rampantly exploited by smuggling syndicates mainly by bribing the enforcement officers on duty. Other factors that aggravate the circumstances are lack of resources, poor security and criminal intimidation (by “mob” elements under the payroll of the smuggling syndicates).

7. The long coastline also accommodates direct smuggling tactics from neighboring countries i.e. Indonesia and the Philippines, whereby smugglers utilize low-draft fast-boats equipped with high-powered outboard motors in excess of 400 horsepower – capable of outrunning any enforcement vessel whether in the open sea or coastal waters. These fast-boat operators (or “tekong”) are also actively involved in human trafficking and drug smuggling and have many times engaged in firefights with the pursuing authorities. They engage “spotters” to keep an eye out for enforcement activity in the vicinity of their landing zone, and have identified several “safe” landing zones in mangrove areas along the coastline, which they constantly change to avoid being trapped in an enforcement dragnet.

7.1. It is considerably difficult for any enforcement agency to mount an offensive to counter or tackle smuggling along the coastline as the access roads are canvassed by the smuggling syndicates and they will immediately alert the *tekong* in case of any attempted raid or roadblock by the authorities. The risk of injury and damage to property is considered far too great at the moment to attempt engaging the syndicates out in the open.

Smuggling Supply Chain

8. In actual fact, there is no confirmed theory as to the *modus operandi* or supply chain in smuggling and there are too many variables to consider. If one were to take the smuggling of cigarettes as the test case, then it is reasonable and logical to assume that a smuggling supply chain will operate as follows: -

8.1. Manufacturers (overseas-based factories)

8.2. Importer/Consignee

8.3. Import agent

8.4. Logistics agent

8.4.1. Transportation

8.4.2. Warehousing

8.5. Distributors/Wholesalers

8.6. Runners

8.7. Retailers

9. The basic cost of smuggled cigarettes at point of manufacture is approximately **USD 0.50 per pack** or more accurately **USD 250 per master-case**. A master-case ("m-c") is the standard unit of measurement for the manufacture and shipping of cigarettes and each m-c contains 500 packs of cigarettes, divided equally into 50 cartons of ten packs each. Each pack contains 20 sticks of cigarettes as stipulated by law in Malaysia. (1m-c = 50 cartons = 500 packs = 10,000 sticks.)

10. The main manufacturers for smuggled cigarettes found in Malaysia are located in Vietnam, Cambodia and Indonesia (Batam) and they have no reservations accepting orders – as long as payment is made accordingly. However, it is suspected that certain syndicates have entered into exclusive supply arrangements with the factories and control the cigarette brand's distribution in Malaysia, which is the case for the brands "John", "Canyon" and "League".

10.1. There is no offence at the point of manufacture simply because it is conducted outside of Malaysia. The factories may accept any order – including private label manufacturing – so long as the goods are not intended for internal sale and distribution, but they also do not guarantee the shipment of the goods into Malaysia.

10.2. Most importers are actually funders i.e. they purchase the consignment and pay for all related costs to its arrival in Malaysia, and thereafter disposes of the consignment – under coordination

of smuggling syndicates – to distributors/wholesalers for a quick and sizeable profit; enabling them to remain detached from the risk of smuggling.

11. The minimum order at the factory is usually a forty-foot container or 1,050m-c (525,000 packs), which amounts to approximately **USD 263,000 (~RM 1 million)**. The manufacturer will ship the consignment using “FOB” (free on board) terms, which means the importer bears the responsibility of declaring the goods and paying any due taxes at the point of entry.

11.1. At this point, certain import agents are introduced to the importer – or have already been arranged by the syndicates – for their unique “capability” to move the shipment out of the port area without being detected by the authorities.

11.2. All required documentation will be prepared and the shipment will be marked for placement in the [Free Trade Zone](#) (“FTZ”), normally using fictitious information for the consignee and notify-parties. It is believed that the shipments never physically arrive at the warehouses in the FTZ and is immediately trucked-out to a pre-identified location for break-bulk and distribution.

11.2.1. Use of fictitious information in declaration forms continue to be an obstacle for RMC to identify the true importers of contraband. The only available course of action is to penalize the import agents who are required to furnish truthful and accurate declarations for all shipments under their management.

11.2.2. Furthermore, there still exist certain standing orders and rules that allow amendments to declaration forms within a 30-day grace period, and this further complicates enforcement actions by allowing import agents to file changes to the shipment manifest and destination, even after being shortlisted by RMC for inspection.

11.3. It is suspected that the import agent will also handle all required documentation to preclude any audit or inspection by RMC or the port authorities, usually by declaring the shipment for transshipment or transit or round-trip back to manufacturer (rejected goods) once it has been delivered to the real consignee i.e. the syndicate.

12. These syndicates already possess a network of distributors/wholesalers and are able to quickly dispose of the bulk shipment upon its arrival, thereby reducing the risk of detection and interception by the authorities.

12.1. This cost of facilitation i.e. to smuggle the consignment out of the port area undetected, may cost the importer at least **RM 100,000 per forty-foot container**, and it is believed that this upfront payment goes towards bribing certain corrupt officers and personnel in the port area to abuse the due process and turn a blind eye, as and when required.

12.2. The process of unloading a forty-foot container laden with 1,050m-c of cigarettes is no easy task and could take a team of five (5) people between 3 – 5 hours to complete, during which time the syndicates are most vulnerable to enforcement raids. Break-bulk locations are carefully chosen and “private” security teams are deployed to canvass and monitor the location prior to arrival.

12.3. It is also highly suspected that the more established syndicates have their own warehousing options and are able to stock-pile the shipments so as to pressure demand and marginally increase prices at their whim and fancy – even at 10 sen per pack, the syndicates are able to rake in millions due to excessive demand.

Profitability

13. The importer or funder generally makes between 20 – 30% profit from the sale of each forty-foot container, disposing of the shipment at between RM 1,200 – 1,300 per m-c (or RM 25 per carton) depending on the brand. The more in-demand brands e.g. “John” or “Canyon” cost between RM 1,400 – 1,500 per m-c due to the tight control by the syndicates that “own” its distribution rights.

13.1. Importers stand to make the most from the smuggling of cigarettes, potentially raking in **RM 400,000 per forty-footer**, as they dispose of the shipment in bulk into the syndicate’s management.

14. Distributors and wholesalers traditionally will apply a much smaller rate of profit i.e. between 15 – 20% and distribute or supply the smuggled cigarettes to retailers and “runners” between RM 27 – 32 per carton. It is

important to note that at this point and further down the supply chain, smuggled cigarettes are sold in cartons for easier distribution (sometimes by bike riders) and to avoid detection by the authorities.

15. Retailers will normally conceal their smuggled cigarettes stock to avoid being trapped by “mystery shopper” activities conducted by the industry and the authorities, which attract heavy fines and confiscation of the contraband product, and repeat offenders are hauled to court to face criminal charges. Smuggled cigarettes are retailed from RM 3.50 – RM 5 per pack and retailers stand to gain between RM 1 – 2.50 net profit per pack and could potentially rake in **hundreds of Ringgit per day** from sales, especially in urban and suburban centers.
16. In any case, the price disparity between legal and smuggled cheap white cigarettes is between **RM 12 – 14 per pack** – refer Chart 3 above. This is a priority point of engagement for the tobacco industry as the price disparity – due to what they claim is excessive taxation on legal sales – is only fueling the demand for cheaper and illegal alternatives, which in turn undermines the government’s ratification of the FCTC.
17. The supply chain for *kretek* is a different species altogether as the number of sticks per pack varies according to the brand i.e. 10, 12, 14 and 16 sticks. The price structure for *kretek* is infamous for sudden hikes but the profit margins are almost the same as for cheap white smuggled cigarettes. Nonetheless, *kretek* sales outstrip that of cheap white cigarettes, which is primarily due to the burgeoning migrant worker population in the country.
 - 17.1. *Kretek* cigarettes are distributed in “*tims*” and each *tim* also contains 50 cartons of cigarettes. The preferred mode of smuggling for *kretek* is via fast-boats from Indonesia due to the pungent odor of cloves, which will require costly measures to conceal during shipment in order to avoid detection, although there are cases of *kretek* being smuggled via air cargo shipments and smaller twenty-foot containers via the land ports and barter trade outposts.
18. However, if the ICS is accurate and the volume of smuggled cigarettes is actually **13.9 billion sticks** (55.6% of the total consumption), thereby it is also logical to propose that a hidden yet professional logistics system is being operated by the syndicates.

18.1. Even for the “Big Three” players in the market, the cost of distribution and marketing runs into hundreds of millions of Ringgit each year, and yet their combined volume is less than that of smuggled cigarettes – in fact, the brand “John” is the best-selling cheap white and its volume is reportedly the bigger than “Dunhill”, the top legal brand by share in the market, which is owned and distributed by BAT.

Intervention

19. Since 2002, the tobacco industry has actively engaged in intervention activities to stem the inflow of smuggled cigarettes or “illicit trade”. Their approach was structured and in accordance to their Anti Illicit Trade (“AIT”) agenda, which focused on the following pillars: -

- 19.1. Regulation
- 19.2. Enforcement
- 19.3. Awareness

20. It should be noted that the industry forged close working relationships with the relevant enforcement agencies in pursuit of a common enemy, as they invested heavily in awareness campaigns and intelligence support services to bolster the efforts of the enforcement agencies, namely RMC and MDTCC, based on their jurisdiction and purview over illicit trade.

21. Towards the end of 2012, the industry coalition or CMTM began to rupture as member companies pursued individual interests on the back of their joint engagement program with the Government. The volume of illicit trade began to increase exponentially and it was obvious that their efforts in supplying intelligence and other support were not bearing fruit. The enforcement agencies also began to push back stating that the strategy devised by the industry was only consuming vital resources with no tangible results to show.

21.1. The tobacco industry ran several projects with the intention of procuring the intelligence on the syndicates and their modus operandi, in an attempt to destabilize the supply chain, but the effort proved too costly and too risky to be continued indefinitely. This included port monitoring, “middle triangle” (distribution) investigations and “mystery shopper” initiatives at retail level.

21.2. There was also an ongoing initiative to submit information on suspected retail points to RMC and MDTCC, which by far was the longest joint initiative between the industry and the enforcement agencies. In essence, despite the voluminous information that was furnished, the agencies could not meet the required numbers to make a dent on the point of sale – simply because they did not have the resources to do so. There was also escalating political backlash due to retail associations complaining that the enforcement raids were heavy-handed and unreasonable.

21.3. The MOH also turned a deaf ear to the tobacco industry and continued to press for compliance to the FCTC by increasing excise rates almost year on year, further exacerbating the price disparity between illicit and legal cigarettes. It is commonly known that the MOH naturally opposes any joint initiative to assist the tobacco industry as they view it to be contrary to the spirit of FCTC.

22. In 2014, CMTM disbanded and the entire AIT structure collapsed onto itself, mainly due to internal malpractices in overseas interests of the member companies. The local tobacco players reeled in all the expenses that was earmarked for AIT projects and focused instead on engagement with the regulators to try and garner political support in their war against illicit trade. By withdrawing whatever little intelligence they provided on the illicit supply chain, the enforcement agencies could only continue with retail level intervention to the best of their capabilities.

22.1. The extent of enforcement actions was also limited to the violent responses from syndicates whose goods were seized during transportation or in storage. To-date there has been no less than ten (10) incidents where government officials have been harassed, intimidated and even where property was destroyed by arson in retaliation to enforcement actions.

22.2. Another stumbling block to effective enforcement was meddling from politicians who godfather-ed the syndicates and would interfere in ongoing investigations and even disrupt prosecutions to protect their affiliates. This was frequently cited as the main reason behind enforcement agencies damp response towards smuggling in general.

23. 2015 proved to be the most arduous yet for the tobacco industry as the Government increase the excise rate to almost twice the previous increase i.e. almost doubling the rate, and this whether directly or indirectly contributed to the biggest increase of illicit trade in the last ten (10) years. The industry reeled from losing more than 55% market share to illicit trade, wiping out billions of Ringgit in potential revenue.
24. More recently, towards the end of 2017, the Minister of Finance II (MOF II) tabled an amendment to the Customs Act 1967 that enabled RMC to prosecute retailers not only for possession of smuggled goods or contraband, but also for the intent to sell – a double-whammy in all regards for retailers. The outcome of this amendment seemingly did nothing to stem the steep incline of illicit trade, again reaching unprecedented levels towards the end of 2017. It remains to be seen whether this amendment had any impact on the sale of smuggled cigarettes as the first wave report of the ICS will only be due to be released in May/June 2018.
25. At this point, it is also unclear if the tobacco industry will continue with the ICS due to such lukewarm response from the Government towards their plight. Sources close to industry insiders claim that the legal tobacco players have thrown in the towel and are preparing to withdraw altogether from the Malaysian market, choosing to operate instead through distributors and agents for the sake of keeping a semblance of market presence.

The beer and liquor industry

26. Smuggling of beer and liquor are quite distinct from the challenges faced by the tobacco industry namely because the smuggled product is actually their own brands, which were manufactured for distribution in other countries – what the industry itself terms "grey market" issues.
 - 26.1. Liquor also faces the issue of counterfeited product, which has been steadily improving in terms of quality. Illegal bottling facilities continue to be surfaced by the MDTCC with the aid of service providers (agents) appointed by the brand owners to provide market sanitization services.
27. In 2015, the beer industry taking a cue from the tobacco industry and finally acquiescing to RMC's request for them to set-up a market vigilance initiative, began to procure intelligence on illegal liquor outlets and submit them to RMC for retail enforcement.

- 27.1. The industry claimed that the domestic market was being tainted by smuggled long cans (500 ml cans) sold below the legal price. This initiative was quickly rebuked by RMC as the containers of beer being seized at port level were all local brands intended for other markets and duty-free outlets.
- 27.2. After a few months of implementation, the joint initiative between the two largest beer brewers and distributors in Malaysia came to a grinding halt with a red-faced beer industry claiming RMC was on a witch-hunt to penalize them over the "grey market" problem, further compounded by the burning issue of back taxes that RMC was demanding payment for.
28. The beer industry continues to garner strong market sales locally, posting bumper profits year on year despite the dozens of containers impounded and hauled up by RMC for infringing the Customs Act 1967.
29. The liquor industry however is more concerned over brand image and reputation due to the nature of its product, which is intended for consumption via ingestion. They continue to engage agents and service providers to scour the market for distribution of illicit goods and pay handsome rewards for its seizure and destruction.
30. Since there is no means of measuring the size of smuggled products in the domestic market – such as the ICS – the only method of analyzing the impact of smuggling on the industry is to measure and compare the volume of seizures year on year, and the numbers are steadily increasing.

A link between cigarettes smuggling and terrorism funding?

31. By its nature alone, smuggling is the most profitable illegal venture in terms of gross income per unit of contraband, with tobacco, beer and liquor the front-runners of the list. Due to this disproportionate rate of income, many criminal syndicates are involved in smuggling to boost their illegal revenue – whether by providing "security" services to the actual smugglers or by evolving into smugglers in their own right.
32. There are countless opinions from respected leaders in the intelligence and crime prevention community that argue there is a hidden link between the phenomenon of smuggling and terrorism funding, whereby smuggling is lucrative and ideal for their modus operandi. This general consensus however has not been completely proven and investigations

are still ongoing to identify the enablers of the financial transactions between the smugglers and known terrorist groups.

33. In Malaysia, whether or not politically correct, smuggling seems to have a broad participation from all major ethnic groups from the top to the bottom of the supply chain, and that is not taking into account the funders and "godfathers" who remain shadowy and strenuous to connect to the syndicates.

34. There is however a possibility that the smugglers who operate over the Thai-Malaysia border and the *tekong* involved in fast-boats smuggling across the Straits of Malacca and the Sulu Sea are linked to extremist and potentially terrorist splinter groups operating in this region, and the same individuals are also responsible for piracy and kidnap for ransom incidents in recent years.

34.1. In 2017, the Police scored a triumph against a smuggling syndicate that was terrorizing its personnel along the Thai-Malaysia border – the "Pak Su" gang. The leader and his main cabal were all arrested and hauled to court using the [Special Offences \(Security Measures\) Act 2012](#) ("SOSMA 2012"). The case is still ongoing but it seems that the syndicate's grassroots have stepped up to fill the vacuum left by their leaders quite effectively, this time more cautious and more organized in their operations.

35. Due to the demanding workload of identifying and prosecuting the "shadow" leaders of the syndicates, the enforcement agencies in general are committed towards destabilizing the supply chain by draining it of their most critical resource – cash. Whether or not this strategy will successfully reduce the levels of smuggling is yet to be seen but the numbers continue to stack against their efforts. Many observers view this strategy as mere window dressing and not addressing the core or root cause of smuggling i.e. the demand for cheap cigarettes.

Chapter 8 ... Recommendations

1. There are several recommendations that are believed will effectively reverse the trend of illicit trade and return volume to the legal market where it can be properly regulated and controlled.

2. It should be discerned by all stakeholders that the issue of smuggled cigarettes in essence concerns **the smoking incidence of Malaysia**, and not the tobacco industry. Whereby it is projected that easy access and the cheap price of smuggled cigarettes will encourage smoking among youths and directly impact upon the national healthcare budget, which will rise in tandem due to the cost of treating [non-communicable diseases](#) ("NCD") - potentially devolving into the No.1 public health concern.

2.1. If left unchecked on its current trajectory, the revenue derived from taxation of legal tobacco players will barely compensate the cost of treating NCD on a national scale, which means the Government will have to either foot the bill entirely or find alternative means of funding treatment, including introducing specific medical cover for smokers.

2.2. A recent telephone survey undertaken by Universiti Sains Malaysia ("USM") under the sponsorship of MOH and RMC discovered that the prevalence of smoking among youths is currently at worrying levels (...%) and that the majority of respondents have heard of or are smoking smuggled cigarettes (...%). *(This survey was only shared within regulatory circles and is yet to be released to the public.)*

3. Dialogue.

3.1. The government and the tobacco industry must return to the discussion table and hammer out their differences for the sake of the nation's future. The issue of smuggled cigarettes is too large to simply disappear overnight as there is too much at stake for the syndicates raking in millions annually.

3.2. The beer and liquor industry are strongly encouraged to participate as it is believed that the syndicates, currently dabbling in both types of contraband, will naturally shift their focus to the more "convenient" of the two due to increased enforcement pressure on smuggled cigarettes. It is within bounds to state that both industries must combine efforts in combatting smuggling in general if they are to continue operating profitably in Malaysia.

3.3. The issue of illicit trade and smuggling in Malaysia has received keen attention from overseas investment managers and private equity groups, who are fixed on the question of whether the

Government will take any measures to curb the illegal activity and support the industries operating here. It is undisputed that tobacco, beer and liquor are the darlings of investors and the Malaysian market has always been a favorable investment ground.

3.4. One particularly prickly issue will be tax or more specifically excise, as another increase would all but put an end to the legal tobacco industry, already hobbling from massive loss of sales. Although a bitter pill to swallow, a tax moratorium has to be implemented in order for the market to correct itself whilst enforcement and preventive activities are being rolled-out.

3.4.1. Although some quarters may argue that this notion is contrary to the FCTC but an argument can be made that such notions are only applicable where there are no external forces disrupting the normal progression of business.

3.4.2. In this context, the influx of smuggled cigarettes is a matter of national security as on a larger scale it impacts upon the Government's capability to protect its sovereign borders. Thereby, the failure to address the steep incline of illicit trade falls squarely on the Government's shoulders as the industry and other stakeholders have repeatedly highlighted it.

3.5. In our opinion, the progressive implementation of the FCTC needs to be put on hold temporarily so that the larger, more pressing issue of smuggling can be sufficiently addressed. Though the use of tax as an economic tool to deter smoking is not denied, it should be also accepted that the tax is only deterring from the legal brands and moving the smoking consumers towards cheaper, more accessible alternatives, which negates the intention of imposing the tax to begin with.

4. Enforcement.

4.1. The enforcement authorities are in need of dire support if they are to effectively reduce smuggling and manage it at acceptable levels in the future. Currently, the RMC is doing its level best to clamp down on suspicious shipments through the ports and this

may have long term effects on the supply chain if not for porous borders and smuggling by sea.

4.2. The physical aspect of smuggling needs to be tackled simultaneously from all points of entry in order to suppress the incoming volume, which will lead to a natural drainage of domestic stocks.

4.3. The impact of multi-angle enforcement is actually advantageous for the Government not just for the reduction in smuggling but also because the consumers will be faced with scarcity of cheap cigarettes, leaving the option of only the legal tobacco products to choose from. This is already a step in the right direction as the high price of legal cigarettes will eventually deter smokers for economic reasons – as intended by the FCTC.

4.4. Joint taskforce.

4.4.1. It will be an uphill battle for RMC to tackle the issue of smuggling all on its own, not only due to lack of experience or resources but also because they are a revenue collection agency and their efforts are focused upon revenue activities, even more so now that the Goods and Sales Tax ("GST") has been abolished and the Sales and Services Tax ("SST") will be re-introduced come September 2018.

4.4.2. To accelerate the response against illicit trade and smuggling in general, it is highly recommended that the RMC form a taskforce consisting of all relevant enforcement agencies and devise a fresh offensive strategy towards reducing the level of illicit trade and suppressing it to nominal levels thereafter.

4.4.3. This taskforce should include the police (RMP), MDTCC, MACC, MOH and AKSEM at the very least, whereby the combined efforts will effectively dismantle the supply chain and flush out the key individuals behind the syndicates, for extended investigation and preventive measures.

- 4.4.4. Tactical response should also be improved with SWAT units being deployed to neutralize violent syndicates, whereby the presence of heavily-armed units will instill fear in would-be smugglers and act as an effective deterrent. This will also boost morale and embolden the enforcement officers and personnel as they can now retaliate justifiably towards dangerous threats.
- 4.4.5. This taskforce should also foster close ties with the enforcement agencies across our immediate borders to ensure alignment and support during covert enforcement actions, especially when in pursuit of the syndicates across international waters and "no man's land".
- 4.4.6. Taking a page from the newly formed *Pakatan Harapan* government, a council of advisors could also be appointed to guide the taskforce in ensuring the most desirable results are attained from their collaborative efforts. The advisors themselves may be retired senior enforcement officers and content experts, to ensure that the taskforce keeps their "eye on the prize" at all times and delivers the expected results within the allotted timeframe.

4.5. Intelligence.

- 4.5.1. Targeted intelligence gathering is crucial towards dismantling supply chains as it provides optimal results for minimum effort expended, ie strategic points and links in the supply chain can be targeted and neutralized to prevent supply from reaching the downline distributors and retailers.
- 4.5.2. Although "old school" surveillance is still considered the best method of procuring reliable intelligence, this method is also known to be costly and without guarantee of success. In order to effectively cripple an organized crime syndicate, vital intelligence needs to be procured from the "inner circle" and this involves the implementation of special measures to safeguard the life of informants and their families, over and above

those provided for under the [Whistleblowers Protection Act 2010](#).

4.5.3. Most enforcement agencies maintain their own internal funding specifically for informant management, which mainly consists of rewards and allowances to keep their registered informant motivated towards the objective. However, in recent years the informant fund has considerably reduced in size and in quantum, causing potential informants to withdraw due to what they view as disproportionate compensation for the risk they're undertaking.

4.5.4. It is our professional view that the Government should not be solely responsible for the upkeep of this informant funding and that corporations and organizations with vested interests should also contribute towards its goal. Corporations especially stand to gain from the effective suppression of smuggling as they're own products will enjoy increased sales due to demand shifting back, driven mainly by necessity.

4.5.5. We recommend that the tobacco, beer and liquor industries sponsor the informant fund to ensure that whistleblowers are sufficiently protected and compensated for their efforts. However, certain safeguards must be instituted to prevent meddling from the donors or even abuse by the administering body.

5. Awareness.

5.1. By far the most important objective is to address the issue of smoking among the Malaysian public, and in the context of the white paper, that will be to tackle the availability of cheap cigarettes in the marketplace.

5.2. Although enforcement efforts will largely contribute towards the reduction of cheap cigarettes volume in the domestic market, the demand for it will not abate unless smokers are educated towards rejecting it, whether consciously or not.

- 5.3. Australia and the UK have both implemented plain packaging in an effort to make cigarette packs less appealing to consumers, but the initiative backfired when counterfeit plain packets began to surface nationwide and "steal" legal sales as a cheaper alternative. The uniform packaging made it notoriously difficult for law enforcement officers to detect and in the end, the policy is facing abolishment due to massive public outcry over the waste of funds and impact on the legal tobacco players.
- 5.4. There is no one solution to the matter of increasing awareness and the "*Tak Nak Merokok!*" campaign run by the MOH should be reviewed to broaden its scope and implementation. Smokers in general rarely quit smoking unless there's an emotional sentiment powerful enough to overcome their addiction, and this usually comes through support groups and targeted incentives that will help them along their recovery process. For all intents and purposes, smoking should be treated as any other addiction in order for it to be successfully contained among the adult population.
- 5.5. To-date the tobacco industry in Malaysia has only rolled-out campaigns to "demonize" the illicit trade and by teaming up with RMC conducted a nationwide roadshow at selected locations to garner public support. However, their efforts barely delivered any results as retailers are too dependent on the profits generated from the sales of the cheap smuggled cigarettes. Unless the issue is gradually stamped out and the retailers leveraged upon as the turning point for the prevention of illicit trade, it is foreseeable that the syndicates will only evolve to overcome the circumstances e.g. by offering higher rates of profit and providing protection to retailers in their distribution network.
- 5.6. Awareness is undoubtedly the key towards ensuring that our smoking prevalence does not increase in the future and it should be holistically planned and implemented so as to touch the hearts and minds of the consumers and public at large. The cost of awareness campaigns in that regard is expected to be marginal against the potential surge in healthcare expenditure if the problem is not nipped in the bud.

Chapter 9 ... Conclusion

1. The issue of illicit trade is bigger and more critical than just the concerns of the industry caught in a headwind. The future of the nation will also be impacted as NCD among adults affects productivity and increase healthcare expenditure.
2. There are solutions available but it requires dialogue and strategic intervention from the relevant authorities with the support of the industries and other stakeholders.
3. The capability of enforcement agencies can be dramatically enhanced through a joint taskforce that is focused on clamping down the illicit trade and suppressing it to acceptable levels. The industry may be of critical assistance by extending support in the form of vital resources to ensure the success of the joint initiative.
4. The issue of taxation has to be resolved between the regulatory bodies and the industries in question. All stakeholders should appreciate the gravity of the issue at hand and work together to combat the threat before it escalates into long term issues affecting the national health barometer.
5. Awareness efforts should be reviewed and rolled out holistically to address the issue of smoking as an addiction. On top of deterring smokers and helping them quit the habit, the retailers should also be engaged as a vital part of the supply chain. Their participation and support of the scheme will ultimately deliver the final blow to smuggled cigarettes.

Chapter 10 ... References

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