

Inter-Office Correspondence

Date: 6 January 2010

Subject: Brand Integrity Global Operations – 2009 Results and Assessment

We estimate that Brand Integrity (BI) operations worldwide contributed to *Total Market Savings* of just over two billion sticks this year, a 35 percent increase in comparison to last year and almost 60 percent above the 2007 results (see Annex 1).¹ Based on an average of the net JTI-to-first customer price of a basket of the Global Flagship Brands (GFB) most counterfeited – Mild Seven for Taiwan and China and Benson and Hedges (B&H) for the United Kingdom and Ireland – this amount could equate to a value of over US\$120 million in recovered potential returns, although the actual positive financial impact of these results is likely substantially less in the near term.² The addition of foregone penalties under the JTI-European Commission Agreement for shipments of JTI cigarettes prevented by BI operations from entering the European Union raises the potential financial return of Brand Integrity activities in the past year to over US\$125 million. The totals do not take into account the positive reputational impact of BI support to enforcement agencies worldwide, which resulted in numerous seizures of counterfeits of other goods, in addition to JTI brands; BI passed to OLAF alone tip-offs on some 79 containers carrying known or suspected counterfeits, the highest number ever passed to any enforcement agency by a company.

- The 2009 *Total Market Savings* sum includes at least 1.14 billion sticks of mainly diverted or counterfeit Mild Seven and B&H that BI operations disrupted or prevented from being produced or introduced into the market; calculated as a *Disruption Equivalent*, and equal to a much greater return on investment to the program than after-the-fact seizures, which often have little aggregate financial impact on the major syndicates.³ In addition, the program contributed to the seizure of 300 million sticks of counterfeit or diverted Mild Seven, B&H,

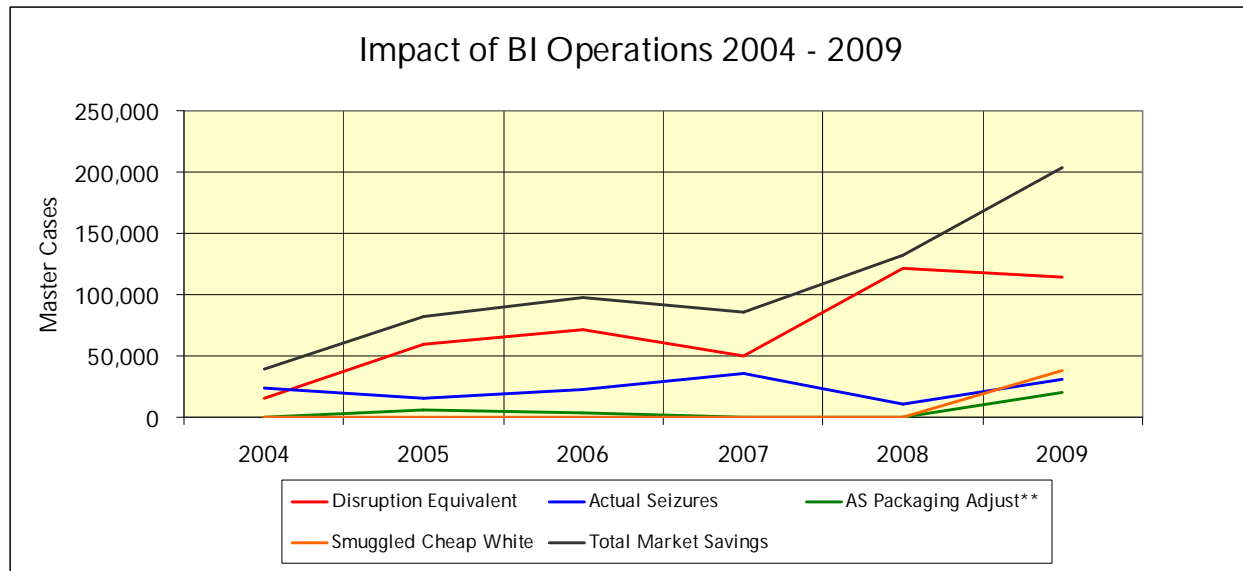
¹ *Total Market Savings* (TMS) is made up of *Actual Seizures* (AS) – those counterfeit, diverted cigarettes, and select smuggled cheap white brands intercepted based on information provided by Brand Integrity or under a program run by BI – and *Disruption Equivalent* (DS) estimates (see following note for an explanation of *Disruption Equivalent*); TMS = AS + DE.

² The financial value of the potential volume opportunity is derived from an average in US dollars of the after-tax per-master case JTI sales price to the first customer of Mild Seven in the duty paid market in Taiwan, Mild Seven duty paid in China, and B&H Gold duty paid in the United Kingdom and Ireland – all key markets and brands targeted by counterfeiters in the past year – multiplied by the Total Market Savings. We use 10,000-stick cases for the purposes of the estimate; for UK and Ireland, we doubled the price of 5,000-stick cases. For the UK, we used the lower “gross margin” versus the “tax exclusive” price and for Ireland took a percentage of the “tax exclusive” price in order to mirror the UK “gross margin” figure. If we remove seizures of smuggled cheap-whites resulting from BI operations, the potential financial impact of BI-linked seizures remains just under US\$100 million. Typically, a one-to-one relationship between foregone sales of counterfeits and new sales of a corresponding genuine brand rarely occurs, although potential additional sales – and subsequently returns – up to this level are now theoretically present. Over the longer term, the positive impact likely will be significantly more pronounced as repeated seizures and disruption operations prompt traffickers, including new entrants to the market, to avoid JT Group brands in favor of those known to be not protected by a pro-active program.

³ *Disruption Equivalent* refers to the amount of counterfeits not manufactured or diverted product not lost from the supply chain due to the efforts of Brand Integrity. We have endeavored to be extremely conservative in estimating the aggregate impact of our preventive or disruption efforts. In terms of counterfeits, we will only claim production or sales equal to or less than that which could have been made or sold in six months or less by the factory or syndicate concerned. The amount is calculated based on an evaluation of the previous production or sales by the syndicate concerned or an assessment based on intelligence reporting or documentary evidence of planned or anticipated output.

and other brands – listed as *Actual Seizures* -- already in or bound for Taiwan, United Kingdom, and other key markets.

- In comparison, BI Operations over the previous five years resulted in *Total Market Savings* of some 1.3 billion sticks – 1.2 billion disrupted or prevented and 103 million seized – in 2008, 860 million sticks in 2007, 976 million sticks in 2006, and, 818 million sticks in 2005, and 391 million sticks in 2004.



Impact of BI Operations 2004 - 2009*

(master case)

| | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> |
|-----------------------|---------------|---------------|---------------|---------------|----------------|----------------|
| Disruption Equivalent | 15,000 | 60,000 | 72,000 | 50,000 | 122,000 | 113,850 |
| Actual Seizures | 24,118 | 15,468 | 22,480 | 36,000 | 10,313 | 31,123 |
| AS Packaging Adjust** | 0 | 6,321 | 3,120 | n/a | n/a | 20,256 |
| Smuggled Cheap White | n/a | n/a | n/a | n/a | n/a | 38,527 |
| Total Market Savings | <u>39,118</u> | <u>81,789</u> | <u>97,600</u> | <u>86,000</u> | <u>132,313</u> | <u>203,756</u> |

Brand Integrity Seizure and Disruption Results 2004-2009 (see attached Annex 1 and 2)

The 2009 Focus and Results

The Brand Integrity Program continues to be heavily focused on finding and preventing or disrupting the production of, or trading in, counterfeit JT Group brands (see Annex 2 *Disruption Equivalent* and a copy of the 2009 BI Operations Work Plan – available upon request).⁴ This year's *Disruption*

⁴ This approach is in contrast to traditional brand protection programs that continue to center around recovering counterfeits after they have been produced and shipped, at which point seizures tend to be individually on a smaller scale – as the product is broken down for wholesale distribution and retail sales – and the financial impact on the traders is significantly less given the much higher profit margins at this stage of the business. For the counterfeit cigarettes business, the reporting indicates that groups operating at or near the wholesale-to-retail level garner returns at least six times those

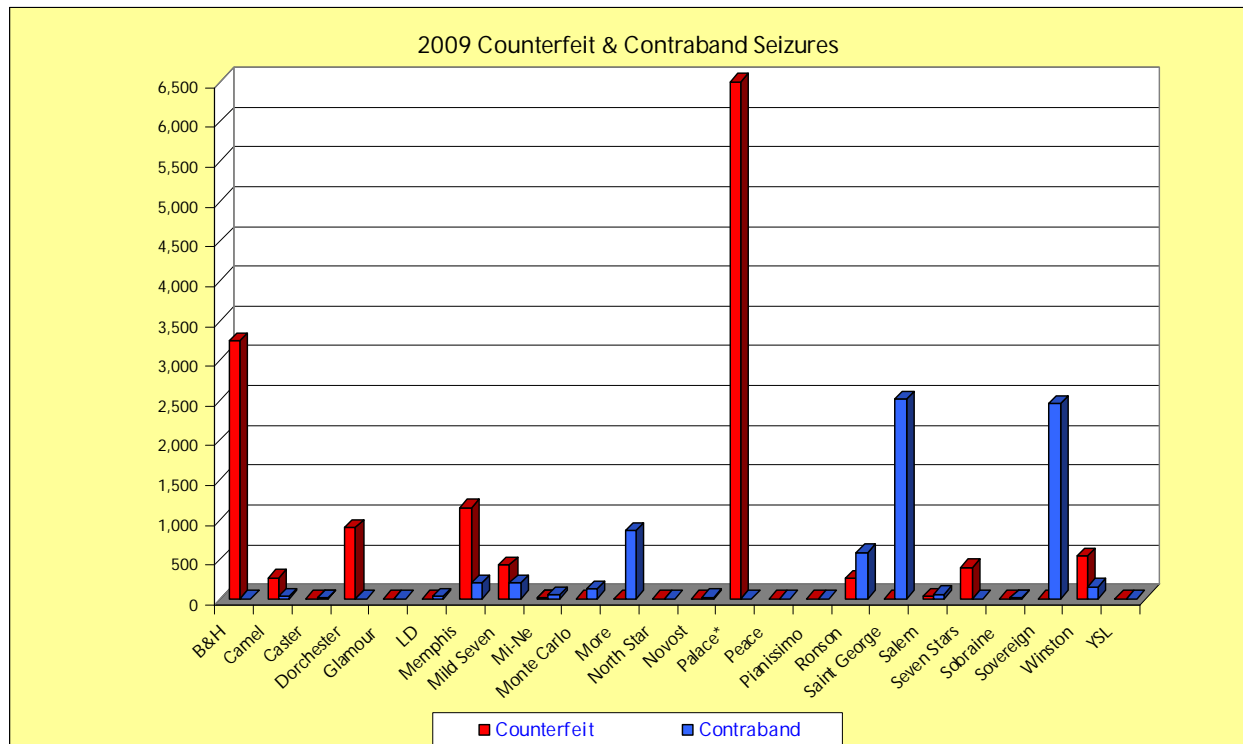
Equivalent of 1.14 billion sticks was dominated by the 300,000 million-stick savings generated by ANNE SCAN Operation, which when taken in combination with last year's Operation CRACKER (see the 2008 Annual Report) and another operation this year targeting Irish smugglers using Spain as an entry point to the European Union, likely has earned additional dividends to the company's business in the Irish and UK markets, as well as serving to further deepened positive ties with local enforcement and regulatory agencies.

- Disruption operations this year also further interrupted the movement of cigarette paper entering the PRC – our operations identified the channels being used to move more than two 40-foot containers of paper each month into China; one container alone carries sufficient paper to produce two billion sticks of cigarettes – a syndicate controlling the movement of cigarettes into the European Union via the Port of Haydarpara (Istanbul), and four separate groups known to sell counterfeit Mild Seven produced in the PRC and North Korea.
- A separate operation halted the sale of genuine Winston diverted from the Philippine market bound for the European Union, which, if it had been intercepted by EU authorities, could have resulted in fines to the company of over US\$4 million.

Total *Actual Seizures* this year were up somewhat from 2008, which were lower than previous years, but were largely driven by very-large flows of counterfeit Palace bound to Ireland. The recovery of sufficient packaging in China to produce over 160 million sticks of counterfeit Mild Seven also dominated results this year and illustrates the fact that Mild Seven continues to be a key potential target of counterfeiters in Asia (see Annex 1).

- The counterfeit Palace, which previously had been produced in large amounts at factories in South Africa and Malaysia, is now being made at a factory in the Philippines, where JTI does not own the brand's trademark. The lack of trademark ownership of this brand precludes our ability to halt production or intercept shipments until they enter the European Union. The tracking of these shipments, and monitoring of production, requires significant expenditures of resources.
- In addition to Mild Seven, B&H – mainly with Irish Tax Stamps – Memphis for the Austria market, and Winston in the Middle East were the main counterfeit JT Group brands intercepted. The Mild Seven, B&H, and Winston mainly came from sources in the PRC, while at least some of the Memphis appears to have originated from one or more factories in the Balkans.
- Intercepts of diverted JT Group brands were dominated by Saint George and More from Russia and old Sovereign left over from stocks previously sold in the Middle East.

generated by production syndicates or their sales representatives. We believe that disruption of the syndicates themselves – which in essence is an effort to influence in our favor the business decisions of the counterfeiters and smugglers and the overall “operating environment” in which they conduct their business – brings a much higher return on investment to the program and, in turn, the company.



2009 Counterfeit and Diverted Product Seizures Due to Brand Integrity Operations

In the past year, we passed tip offs to law enforcement globally on 200 containers – and several large bulk consignments – known or suspected to be carrying counterfeit or smuggling cigarettes or other contraband. Most of the tips offs – 79 containers and three bulk shipments – were passed to OLAF and have resulted to date in over 20 seizures with many still pending. The 79 tip-offs passed to OLAF are more than any other private company, or even any official agency, has ever generated in a similar period of time.

- Many of the other tip offs – some 59 in total – were passed by investigators working under our joint port watch program with BAT to Malaysia Customs and resulted in large seizures of cheap white brands being smuggled into the country.
- The remaining tip offs were passed to law enforcement elsewhere globally, including an additional 30 containers identified to authorities in Romania, Ireland, Spain, Turkey, Malta, Italy, and elsewhere in Europe.

Brand Integrity continued to focus on out-reach and, in cooperation with Corporate Affairs and other internal stake-holders, building ties to law enforcement. In the past year, Brand Integrity directly or using qualified service providers trained some 1,500 law enforcement officers in product recognition techniques. Most of the training focused on mid-to-low level enforcers in Taiwan, Vietnam, and Malaysia, but also included senior officials trained in Trier and over 30 officers sponsored to attend the annual International Association of Chiefs of Police conference in the United States.

- Brand Integrity also supervised the destruction of over 7,000 master cases, and large amounts of packaging, of counterfeit JT Group brands worldwide (see Annex 1). Tracking the secure storage and then prompt and total destruction of counterfeit produce remains a problem in many countries globally and continues to be a focus of our outreach efforts with law enforcement.

2009 Global Market and Enforcement Trends

The trade in counterfeit cigarettes continues to be extremely dynamic and characterized by rapid innovation in production, communication, and shipping techniques and in the identification and exploitation of weaknesses in enforcement regimes, including those instituted by individual companies to protect their brands. The emergence of new “flip ports” – ports and free-trade zones used to re-document shipments in order to hide their provenance and content – and secure “entry ports” in the past year highlight these trends. The continuing focus on developing new cheap white brands – many of which mirror the most popular features of leading brands in key markets – and the exploitation of loop holes in trademark enforcement and security markings also illustrate the adaptability of the business. One troubling trend is the cross-over between the trade in counterfeit cigarettes and “hard-core” criminal enterprises, including weapons trafficking and narcotics smuggling, as well as the involvement of persons associated with terrorist groups in running or protecting the trade.

- Growing Importance of “Flip Ports.” The traffickers have for years used ports such as Manila and Subic Bay in the Philippines, Haiphong in Vietnam, and Jebel Ali in the United Arab Emirates to re-document shipments of counterfeit or smuggled cigarettes in order to either hide their ultimate destination, origin, or the brands involved. In the past year, however, this trend has seemed to reach a new height with many – if not most – shipments of counterfeits, diverted product, and smuggled cheap whites bound for Europe going via Jebel Ali, Port Said and Alexandria in Egypt, and Famagusta in northern Cyprus. Shipments bound for Iran, meanwhile, have been noted moving via Mersin in Turkey, Famagusta, Beirut, Tartus in Syria, and even Tianjin in the PRC. In each case, given high levels of corruption in the ports concerned, and/or legal limitations on investigations, the traffickers currently have the flexibility to operate and re-direct shipments as needed.
- Identification of EU Entry Syndicates and Spot Markets. As we have focused additional resources on identifying the routes and techniques used to move shipments of counterfeits into the key markets on the European Union it has become apparent that the smuggling syndicates exploit weak or corrupt enforcement in Piraeus and Thessaloniki in Greece, Mersin and Haydrapasa in Turkey, and Barcelona and Valencia in Spain to bring shipments into the European Union with relative impunity. In the later part of the year, additional inflows of shipments suggest that Rotterdam in the Netherlands and Riga in Latvia may also be ports being used to gain entry to the European Union. In each case, one or more syndicates seem to “control” use of the ports concerned and often bring in shipments “on consignment,” which they then offer for sale on a “spot market” basis to regional smugglers.

- Cross-Over to “Hard” Criminal Businesses and “Terrorists.” Based on information we have passed to law enforcement in the United Kingdom, Ireland, Spain, Russia, and the United States, and follow on investigations conducted by these agencies, it is clear that as early as 2007 groups involved in smuggling cigarettes have also crossed-over into dealing in weapons, narcotics, and other “hard” criminal businesses. In several instances, the enforcement agencies have encountered – and in some cases arrested based on our information – persons currently or previously associated with known terrorist groups.
- Continued Rapid Growth in Smuggled Cheap Whites. The smuggling of cheap-white brands continues to grow in the face of limited or no enforcement by official agencies in the production regions or transit ports. Our reporting indicates that many, if not almost all, of the principal smuggling syndicates that previously specialized exclusively in moving counterfeits and diverted product into Taiwan now focus largely on the cheap whites, many of which are made in the Philippines, Indonesia, India, and Cambodia, and are mainly smuggled into Taiwan via the Philippines. Producers in these countries, as well as Russia, the Ukraine, and South Africa, also make cheap whites that are ultimately smuggled into the European Union.
- PRC Still Dominates But Shift to ex-China Production Continues. The overwhelming bulk of the counterfeits intercepted in Taiwan, Europe, the Middle East, and the CIS – with the exception of most of the counterfeit Palace – originated in the PRC. At the same time, the movement of the production of counterfeits to underground operations in or near key markets continued in the past year. The on-going official raid program in the PRC largely – but certainly not exclusively – seems to preclude traffickers from making the investment needed in machinery and materials to produce high-quality counterfeits that appeal to customers in Taiwan and the key European markets. Production proximate to destination markets also cuts down on the costs and risks of transport and the need to deal with unknown partners in the face of few means to mitigate counter-party risk. New producers in Russia, the Ukraine, the Balkans, and Laos have been identified in the past year – Brand Integrity in the CIS passed information to law enforcement leading to raids of nine factories in Russia, Ukraine, and Kyrgyzstan alone in 2009, recovering evidence of production of counterfeit North Star and More – while production in northern Iraq of counterfeit Winston and Magna for the Iran market continues, and reports of nascent production in the UAE of Winston for the regional market and Europe continue to be received.
- European NTM Flows. The flow of blended tobacco and non-tobacco-materials (NTMs) from overseas suppliers and those in the PRC – who export and then smuggle loads back into the country – continues to be a critical part of the business. We have noted more than two containers each month of cigarette paper being smuggled into the PRC. One 40-foot container of paper could be sufficient to supply the production of two billion sticks of counterfeits. Assuming five percent of these are international brands, just one container of paper could result in almost 300 containers-worth of counterfeits bound for overseas markets. Europe-based firms continue to dominate this trade, despite our passing details on the smuggling and the remitting of funds to accounts in Europe to enforcement agencies.

- Rapid Product Innovation. The counterfeiters continue to exhibit a capability to very rapidly – in some cases in less than two weeks – develop new packaging, defeat and replicate security features, and find new ways to exploit weaknesses in our production and supply procedures. The sizable seizures of B&H with Irish Tax Stamps and Mild Seven with the new Taiwan packaging are cases in point. In parallel, the re-packaging of Vietnam domestic and China Duty Free Mild Seven and Salem bundles into counterfeit packaging marked for the Hong Kong duty-paid market illustrate the adaptability and innovation of the counterfeiters,

In tandem with the rapidly evolving threat from counterfeiters, the distortions prompted by very sizable differences in tax regimes and market prices in proximate markets, in combination with the low-threshold financial penalties called for under the European Commission – JTI Agreement, has resulted in an upsurge in seizures on the part of EU Customs Authorities of apparently diverted JTI brands, principally Saint George and More from Russia. In December alone, some 25 seizures, of over 8 million sticks of JTI brands, were reported mainly in the Baltic States, but also elsewhere in Central and Western Europe that require inspections to determine if they meet the criteria for penalty payments under the terms of the Agreement. If all of these most recent seizures result in penalties, the potential costs to the company could reach US\$1.5 million.

- The resource implications for Brand Integrity also are significant given the large number of seizures requiring inspection, the requirement to conduct follow-on investigations to determine the exact provenance of the cigarettes, method of acquisition and smuggling, and the person involved in the trade; and efforts to find and prevent any future outflows from authorized distribution channels.

Focus for 2010

Pending completion and approval of the *Brand Integrity (Operations) – 2010 Work Plan*, Brand Integrity will continue to focus on identifying and subsequently disrupting the operations of the principal groups trading in counterfeit or diverted GFBs for the Taiwan and other key markets globally. We will also devote resources to building Destination Market Enforcement programs in Russia and Iran, and further developing those programs started in the United Kingdom and Ireland in 2009, as well as the PRC Production Region Enforcement program. A focus on rapidly inspecting and determining the source of diversions entering the European Union is required and will take up substantial Brand Integrity time and resources in at least the initial part of the year. At the same time, we will need to focus on shutting down the production of high-quality counterfeits of JT Group brands in northern Iraq that are bound for Iran, and monitoring for new production in safe-havens such as the United Arab Emirates, Laos, and possibly Indonesia. Further work on building programs – hopefully in cooperation with the brand protection units of the other major tobacco firms – to identify and then intercept shipments of counterfeits moving via the “flip” and “entry” ports will be critical.

- BI Regional Directors will brief Regional Presidents and their staffs, as well as the General Managers of key markets, on the *The Brand Integrity (Operations) – 2009 Work Plan* once it is published later this month or early next.

ANNEX 1 – BI Global Seizures and Total Market Savings – 2004-2009⁵

See attached charts.

ANNEX 2 - Disruption Equivalent Savings – 2009

As this Annex includes the names and details of persons, firms, and other legal entities involved in trafficking counterfeit and diverted JT Group brands, it will only be passed to individual recipients at their specific request.

⁵ This Annex includes only those cigarettes seized due to the efforts of BI Operations, which includes tip-offs to law enforcement or participation in ongoing Destination Market or Production Region Enforcement Programs. The Annex does not include seizures of counterfeits of JT Group brands or diverted product which were recovered without input or information from Brand Integrity. The AIT Database is the document of record for all seizures.