

# Pariahs, predators or players? The tobacco industry and the end of smoking

written by Clive Bates | 12 June 2017



What would he do?

Given the confusion, anxiety and indignation that surrounds the role of the tobacco industry in tobacco harm reduction, I thought it would be interesting to imagine how a tobacco company chief executive might be thinking about vapour, heat-not-burn or other low risk products. Here's my best shot - perhaps erring on the side of optimism. Feel free to imagine differently in the comments, especially if you are actually in the industry (you are welcome to post anonymously) or are unconvinced or if you are actually a tobacco CEO you can have the right to reply!

1. Technology trend - fundamental. You recognise the underlying technology change in the consumer nicotine marketplace is *fundamental* not just a new niche. And, unnoticed by many, it relates to *energy* - the power and energy density of modern batteries now allow viable competitive products to challenge products where the underlying energy source is combustion

of organic material. And you know combustion is *the problem*. It is now possible to create a nicotine-bearing aerosol without combustion in a reasonable consumer-friendly form - a tipping point in battery technology has enabled a tipping point in the alternatives to cigarettes. Given the underlying development in this area is driven by smartphones, this effect will only get stronger. Once the basic energy problem is cracked, an innovation war can and will commence: aerosol droplet size and mobility, flavours & diluents, free nicotine availability, other pharmacologically active ingredients, sensory impact, control and feedback, data gathering, usability features, temperature control, new heating technologies, heated flavoured tobacco products, aesthetics and branding ... all potential areas for intense innovation and competition. These products have advanced beyond recognition in the last five years. What will the next five, ten or twenty years bring? A lot of disruption is coming up and you either fear it or embrace it.

2. Proof of concept - Sweden. You've also seen what is happening in Sweden, where smoking prevalence has fallen to seven percent and daily smoking just five percent ([May 2017 Eurobarometer](#)). With alternative nicotine delivery the much vaunted endgame is possible. But end of what? And is that a threat or an opportunity?
3. Consumers - assertive. You see consumers already migrating to these products at a rapid rate by historical standards . For your customers, there isn't just a rival *product* in the market, but a rival *value proposition* - much of what they like about smoking, some other geeky things too, but a fraction (if any) of the death and disease, less smell, mess and stigma, and probably at a lower cost. The customer is king, and the customer is *very well served* by these new products. The more these products can match or surpass the smoking value proposition (which they will over time), the more rapidly the market will shift. These are consumers (and products) for the internet age, and they *know stuff*. A giant eco-system of social media, vape stores, advocates, pundits, reviewers and experts are all owning the message and teaching each other. You recognise you can't act against their interests or they'll take their revenge in the market place. You have wound back some of the positions you took earlier as your consumer insight has advanced.
4. Competition - a lot more. You see new competition and competitors *everywhere*. From other tobacco companies, from non-

tobacco nicotine companies, from counter-culture vape stores, from the black market in e-cigarette and liquids, from DIY mixers, from high powered e-cigs, from heat-not-burn, maybe a revival of smokeless. The internet is changing the retail world and consumers' brand loyalty is to the next cool thing, not to you. The historic order of stable tobacco industry market shares, persistent brand loyalty and customers-for-life is fracturing. Your history of oligopolistic pricing behaviour, in which you put up prices and relied on low elasticity of demand to make even more money, is under stress. Now the *cross-elasticity of demand* with vapour products will threaten your 'pricing power' in the cigarette market, with tax policies adding to the pressure and plain packaging making price competition more intense.

5. So what's your best move? The most important thing is to be a strong competitor in the new product markets... you need to be in this game and aggressive with it. Your interest (and your board's and shareholders') is in maximising the medium-term total profit pool of the business - both combustible and non-combustible. If someone stops using your cigarettes and switches to a rival vaping product you lose all the profit stream from that customer. Equally, if a rival's cigarette customer is considering a switch to vaping, you might persuade them to move to your product and gain market share. Either way, the disruption in the market requires you to have the best products you can offer - to defend market share or to take market share. There really is no other way. Some have suggested you might make mediocre products "to keep people smoking"... but you know that's not an option. In a competitive market, you'd lose the smokers and the vapers.
6. Arms race in R&D. What if your competitor produces the killer product (no pun intended), the equivalent of the iPhone and smartphones that ultimately crushed one-time cellphone market leader Nokia? You need to invest heavily in the labs and in consumer insight, and keep your eyes open for acquisitions - what is moving, but underpriced? You are still in the traditional consumer goods business, but with a fast-moving tech business (with tech financials) embedded within. You need to act like a tech business and up the pace and depth of innovation. Who wants to be the *Nokia of Nicotine* or the *Blackberry of Big Tobacco*? Your existing consumer base could move rapidly if they were confident in the health and welfare benefits and these products felt good to use - and they will.

It's just that they may not move to *your* products.

7. Portfolio or silver bullet? Maybe you can storm the market with a single super-innovation: the 'silver bullet' that blows away the competition. But you resist the idea. Led by the customer, you see heterogeneity developing in the market, and this contrasts with the quite homogenous character of the cigarette market, where the diversity is in the branding rather than the product. But with the new products, it seems that different consumers will want different product categories. Their preferences may change over the course of a day or according to their situation. They may shift through products through a long transition from smoking. And of course some countries will have regulation that greatly, if arbitrarily, favours one product category over another. So you resolve to develop a portfolio and to have "a dog in every fight".
8. High margins. You are cautiously optimistic: it is possible the company will make even more money if the margins on the new vape products are high (which they are under current tax conditions). To sustain premium pricing, you try to make proprietary devices with consumables that only work with your products so you can charge a reasonable premium for them. For this to work you need strong marketing and high quality products that are easy to use to build a premium brand, otherwise customers will drift away to cheaper products and liquids. If you believe you have a strong product, then you want the tax on it to be low. If you have a weak product and are on the defensive, perhaps you would like the tax authorities to shield you from low-priced superior competitors and you want relatively high tax. There isn't a single industry view on tax because it depends on *relative* strengths *within* the industry.
9. Low margins. Even if the margins head lower and competition squeezes your ability to raise prices, what's the alternative? If you don't have the best products your competitors will still take your customers - you lose *all* of a smaller profit stream. Your job is still profit maximising, even if that means compensating for the decline in profitability by holding and winning market share with superior products and marketing.
10. A bigger market fed by recruiting kids? As chief executive, measured primarily on shareholder value (stock price) your concern is mainly for sales over the next five years as that is what will dominate your stock price (though the tech business financials are different and focus on

market share and customer growth). Your focus is not on growing the total market for nicotine, but on winning as much of the evolving nicotine market as you can. It's about market share and who will gain it and lose it. But, one thought for the long game - maybe recreational nicotine, if no longer deeply conflated with the horrors of cancer, cardiovascular and lung disease, will see a revival in the long run and usage may go up as disease comes down - at least that is [what economists would expect](#).

Some say that in the long run you will need to recruit kids, riffing on the familiar argument about replacing dead smokers... but you don't see it that way: if it is an adult habit freely chosen and with minimal mortal risks, it's like any other adult product or even any other product. Right now your concern is competition for adult smokers.

11. Becoming a former Merchant of Death. You glimpse the future and see that in the long run, you can get your company out of the 'Merchant of Death' business by migrating to products that have near-zero or low risks comparable with other lifestyle choices - if the consumer wants to go there. You like this idea: it will be good for morale to shed some pariah status and it may reduce the company's legal liability. Consumers are heading that way, technology is heading that way, there is money to be made, and reputations to be gained. You remember the 'Kodak moment' as digital cameras wiped out film, and then phones wiped out most digital cameras. You declare publicly that this is your direction and you want to "obsolete the cigarette", not by regulation but by having something better.
12. Stop selling cigarettes? But the vast bulk of the company's cash and profit is still from cigarettes. You are hearing calls to stop marketing cigarettes "to show you are serious". You know you can't do that: if you tried it the shareholders would object and you'd be fired and replaced with someone who looks after their money. Or the company would be taken over and you'd still be fired. If you tried it and no-one else did, then your customers and their cash-flow would migrate to your rivals. There may not even be any benefit to health, *and* you'd be out of a job. There isn't much scope for that sort of heroism, especially unilateral heroism. So you define the challenge differently: "*how do I make the most rapid transition possible, consistent with my duty to protect the interests of shareholders?*" You can't do the former without the latter ...or you are out of a job. And besides, you need to put the money in the cigarette business into R&D to

create the products of the future that will keep the company profitable. Normally you just hand it out in dividends, but now you have a reason to retain some earnings and to invest.

13. Set a date for phasing out cigarettes? Critics want you to name a date by which you would be out of cigarettes. Hold on. Not that simple. And so you decline to be pinned down to a date. Critics say: 'told you so', but you know you are right. The reason is obvious - you don't control the rate of transition. The rate of transition is a product of many things - the policy and fiscal framework, the communication of risks and benefits of the products, how much marketing you can do, what people say about the products (if your low-risk products are denounced by the U.S. Surgeon General, then you expect the transition from high-risk to low-risk to take longer) and consumer preferences. In fact you only control a small part of a large eco-system of influences on the rate at which non-combustibles obsolete cigarettes - the 5Ps of marketing (product, price, promotion, position and people) and you don't even control most of that, given it is subject to regulation.
14. Same old bad practices in developing countries? You are accused of making this a first world thing and carrying on dirty business as usual out of sight in poor countries. You know that it will be difficult to ramp up production and ramp down costs at such a rate that you can promote transition in every market in the world simultaneously. You go first to where the margins are best, the regulation most favourable and the consumers most aware. You need to carry on fighting for market share in the traditional cigarette business, that's your job, but you are more concerned now about reputational risk and the global visibility of your marketing practices via social media to your potential customers, so you resolve to get more disciplined even if it costs. Actually, you have another and bigger worry about developing countries: the World Health Organisation and its Bloomberg-funded outriders seem determined that you should only sell cigarettes in poorer countries. They are busy encouraging bans on low-risk products. You wonder: *why would they do that?* Is this some sort of modern imperialism? Why make it lucrative to sell cigarettes and to run a black market in vapour products? You lament, but there is little you can do - they won't talk to you.
15. Regulation. You turn your attention to the thing that shapes the market as a whole: *regulation*. What sort of regulation would you want? Hmm...

not straightforward! So many questions: do you want to accelerate the transition because you are in a strong position *relative to other companies*, or slow it down because you are weak? Are you concerned only about your company's immediate interests, or are you looking at the evolution of the market as a whole for which you could build a consensus? Are there rivals that would become more threatening or attractive to acquire if regulation changed? As far as that transition is concerned, where could you have common ground with public health, or part of it, and where would your interests diverge? Is perverse public health regulation stopping you moving at the pace you would like? Are you backing things that protect you from competition, but massively annoy your customers? If you pushed for tougher regulation of cigarettes (or stood aside while it was imposed), would that force complete quitting, switching to vaping or diversion to the tobacco black market? Are you on the side of your hapless customers by protecting them from tobacco policies or on their side by helping them to switch?

16. Go for it. So you determine that you have or will have pretty good alternative products and anyway, fortune favours the brave... there are reputations to be gained here. What sort of regulation might you support to accelerate, and profit from, this transition?
  - Tax differentials that encourage switching? You want the tax system to support the strategy you have. Some jurisdictions are already killing off the fiscal incentives to switch, so they are slowing the rate of transition and making it harder for you to obsolete the cigarette. You might want some tax to add burdens to smaller competitors and to reduce the advantage that the vaping category has over cigarettes so that you aren't losing too much share to non-tobacco nicotine companies. You don't really favour taxation that is literally proportionate to risk, because you think greedy tax authorities will take what they can and pay lip-service to risk, but you want differentials that go some way to reflecting risk.
  - High technical regulatory barriers to entry? At first sight, it looks like exhausting paperwork, testing and technical barriers to would serve you well here. You have a fat cash flow from cigarette sales with which to cross-subsidise vaping operations. Burdensome regulation will slow down or crush the smaller competitors and

make sure the pace of innovation is slowed down to something you can keep ahead of. And happily, no need to try too hard with this one - you already have most of the public health advocates pushing for a highly regulated market in which only you will thrive. The limit to this however, is the threat of the internet trade overwhelming the regulated market and leaving your more expensive products marooned on an island of high costs and slow innovation. So you rethink, and come more into alignment with the smaller companies - reasoning that you can be a big player in a more diverse market (like AB Inbev and SAB Miller are in the beer market but coexist in competition with craft brewers). So what matters is that the market is legitimate and orderly and not drawn into black market responses. You decide to focus on regulation that is just enough to create material benefits or risk mitigation for consumers. You reject the predatory option of using regulation to wipe out smaller competitors.

- Marketing freedoms? Yes, please. You want as much freedom as you can get to advertise the vapour products, but subject to limits on content that tends to discredit the industry as a whole. If you can't advertise the new products, then how can you build brands and get the consumers into the new low-risk products? Again, relative strengths may play a role. If you have a vaping product, you may be inclined to see heat-not-burn tobacco advertising banned. On the other hand, beware what you wish for - who knows what the company will be selling in even five years from now. You favour broad freedoms - the right to promote better, safer products would hasten the transition. Once again, you lament that well-meaning efforts to restrict marketing by public health are slowing down the transition, and you shrug again - more years of earning immoral but lucrative profit from cigarettes lie ahead. *C'est la vie.*
- Risk claims? A key driver of switching is the belief that the new products are much safer than smoking, and you share the conviction of PHE and RCP that they are *much* less risky. But you are acutely aware that most potential users of these products have no idea about *how* risky they are and most grossly overestimate the risk relative to smoking. So this risk



misperception is blowing your key USP. Again you are torn... do you favour a very burdensome approach to claim-making (like FDA's MRTP or a medicine marketing authorisation) because this would give you - and not many others - the ability to make claims?

Do that and the advantage would be attributed to your product, but not to others that are almost the same. On the other hand, you might benefit from wider awareness of reduced-risk products.

Maybe it matters less what you say about your products and more what others are saying?

- Use in public places? The thing you most need here is the right of property owners to make the decisions, neither an unfettered right to vape or a legal prohibition of vaping everywhere smoking is banned. If the market can provide enough places where vapers are welcome, then maybe that will add to the value proposition of switching and make it more attractive to switch. Banning indoor vaping might drive new vapers back out with the smokers and leave them resentful and prone to relapse, again slowing the pace of transition. Once again, it looks like public health is doing the devil's work and forcing you to keep making money from cigarettes. If you were a weak company in the vapour market, you might not mind too much about public health inspired vaping bans, as they protect your cigarette market.
- Age restrictions? Of course, you say these products are for adults aged 18 or over and the advertising will be pitched at 25 and over. And you do actually mean it. Marketing to kids is the reputational road to hell and just not worth going down, even if you wanted to. No kiddie flavours, no childish marketing, no vending machines. Nothing like that. There are plenty of adult smokers to go after for the foreseeable future. But privately, you think there are still lots of kids smoking despite the age restrictions, shouldn't someone (definitely not you) encourage (or not discourage) these kids to vape instead if they would otherwise be smoking? You conclude that the age restrictions are part of a 'license to operate' and you should stay out of the heated debate about how vaping may benefit kids who would otherwise smoke. Everyone else is glad you do that too.

17. A coalition of the willing? You want to change your business and get out of

the death racket at the greatest rate possible. Surely that's a good thing that everyone can agree with. Maybe you can get some momentum up with regulators, legislators and the expert community? Alas, you find your traditional enemies remain your current enemies, lodged in comfortable trenches with their bayonets fixed fighting the war they are most at ease with, *whatever* you do. You lament their lack of curiosity and apparent hostility towards the power of capitalist animal spirits to tackle the smoking epidemic from within. But you aren't going away, and you are making more money and are more highly valued than ever. You can make money by selling cigarettes if they are determined to force that on you.

Note from me, Clive Bates, no longer trying to play a Big Tobacco CEO. It has been interesting to reflect on this. The role regulation could play in a transition from high-risk to low-risk is, I think, critical, yet the conversation with and within public health on these issues is mostly infantile, and that needs to change.

I think the companies have *mixed* incentives in this area - there will probably not be one single industry view on regulation. This is because they are strongly motivated to pursue market share during the upheaval caused by disruptive technologies and are incentivised to favour regulation that reflects their strength or weakness in the market *relative* to their competitors. Some of their positions on regulation will align with public health interest (generally when they have strong reduced-risk products) and will tend to be misaligned when they are relatively defensive (i.e. with mediocre products or no products in a category).

Some will have temptations to press for regulation that is more burdensome and predatory than is in the consumer interest, but that damages weaker or smaller competitors. This is an area of possible divergence between public health interests in harm reduction and tobacco industry interests in harm reduction - the latter may press for more demanding regulation in some areas for *predatory* or *defensive* reasons. It is also an area where genuine public health advocates need to engage.

What is completely and unambiguously insane to me is that so much of the regulation favoured by regulators and public health activists works to protect the cigarette trade and shield the companies with poor products from competition. David Swenor famously characterised them as [Big Tobacco's Little Helpers](#). But I think it is even worse than that. The self-defeating anti-harm-reduction hawks

actually want regulation that will obstruct the tobacco industry overhauling its business model. They aren't helping anyone, including Big Tobacco... just defending a *legacy* business model that they are comfortable with and feel virtuous fighting.

See also: [How Big Tobacco sees its future](#), guest blog by Jon Fell