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Tobacco-Settlement – Bankruptcy

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TREASURY ASSISTANT SECRETARY

FOR FINANCIAL MARKETS

GARY GENSLER

SENATE TOBACCO TASK FORCE

Chairman Conrad, and distinguished members of the Task Force, I am pleased to appear before you today. I joined the Treasury Department last year, after working for 18 years on Wall Street. As a partner of the Goldman Sachs Group, L.P., I was fortunate to have a variety of experiences that help inform my understanding of bankruptcy issues in the tobacco industry. During the 1980's and early 1990's, I was a senior professional in the firm's merger effort. In that capacity, I valued companies and advised clients on how to assess businesses. That is what I hope to do here with you today. After I left the merger department, I gained both trading and international experience as the head of Goldman Sachs' debt and currency trading efforts in Japan. As a bond trader, I assessed how world and market events affected the valuation of bonds and their underlying credits. That experience also bears upon the views that we will be presenting today.

Jon Gruber, Deputy Assistant Secretary for Economic Policy, is here with me to help address any of your questions. Mr. Gruber has been with the Treasury Department for the last year, and is also a professor of economics at the Massachusetts Institute of Technology.

My testimony will consider the effect of comprehensive tobacco legislation on the risk of

insolvency in the tobacco industry. To best understand such effects, I will begin by providing the Task Force with a brief overview of the tobacco industry and its business characteristics. I think that you will share our conclusion that the industry is currently financially strong and viable, but not without risk. This financial risk, which has been endemic to the industry for many years, arises from uncertainties related to litigation concerning the companies' business practices. Subsequently, I will turn to proposed legislation and its implications for the tobacco industry's overall financial health. Finally, I will make some observations about how bond investors assess the tobacco industry's credit risk.

1. Industry Characteristics

The U. S. tobacco industry is financially strong. It is comprised of four major companies: B.A.T. Industries, Loews, Philip Morris, and RJR Nabisco. (A fifth company, Liggett Group, has a market share of just over one percent.) As presented in Figure A, these companies had combined revenues approaching $150 billion last year. They had operating earnings in excess of $23 billion. Their combined stock market value is $145 billion. By all of these measures, this is a large and viable industry. It also is concentrated as an oligopoly among only a handful of players.

These companies also are well-diversified. As presented in Figure B, only one-third of the industry's operating earnings is derived from domestic tobacco. International tobacco sales accounted for 27 percent of operating earnings. Moreover, each of the companies in the industry has diversified holdings in other businesses. With interests in food, beer, financial services, and hotels, the industry owns such familiar companies as Kraft Foods, Miller Brewing, Nabisco,

CNA, and Loews Hotels. These non-tobacco interests accounted for 39 percent of earnings last year. As can be seen, the industry does not, by any means, rely solely on domestic cigarette sales to stay profitable.

2. Business Characteristics

The tobacco companies share several business characteristics.

First, they enjoy significant brand loyalty from their customers. With such strong consumer franchises, the companies benefit from significant barriers to entry. Moreover, the industry's limited potential for technological innovation helps to maintain these barriers. In addition, potential marketing restrictions are likely to raise these barriers and strengthen their franchises.

Second, cigarette sales are highly concentrated among the top brands. The leading product, Marlboro, accounts for approximately one-third of all domestic cigarette sales. The top dozen brands together account for 80 percent of domestic cigarette sales.

Third, the tobacco business has very high operating margins. Loews, Philip Morris and RJR had combined operating earnings of 38 cents on every dollar of domestic tobacco sales last year. Even the smallest among them, Loews, earned 22 cents on every dollar of tobacco sales. These generous industry margins are over three times the average profits enjoyed by American industry as a whole.

The industry benefits from advantages on both the revenue side and the cost side of its business. The strength of brand names and the industry's oligopolistic nature give tobacco companies substantial pricing flexibility. At the same time, the industry's cost structure is

largely variable (i.e., directly related to output), allowing the industry to more readily adapt to changing environments. Approximately two-thirds of costs are selling, general and administrative costs. Dominated by distribution, marketing, and advertising costs, these are largely variable. Manufacturing costs, which make up the remaining one-third of costs, also are dominated by variable costs, such as the purchase of raw materials and packaging.

Fourth, the industry has provided smooth returns over many years. Contrasted to many industries, the tobacco industry has had relatively modest volatility in revenues or earnings. This is especially relevant in analyzing insolvency risk.

Fifth, the tobacco companies recently have experienced growth in international sales. The companies are profitable in many countries, despite having lower market shares in foreign markets. More importantly, they are profitable even in countries where cigarette prices are significantly higher than in the U.S. For example, they profitably compete for sales in the U.K., Denmark and Norway, where the average price for a package of cigarettes is more than than twice as high as the price in the domestic market. Under most estimates of price increases under the proposed legislation, prices in the United States are not expected to reach the current levels in many foreign countries.

On the other hand, however, the companies have been confronted with declining demand in the U.S. Over the last five years, domestic demand has dropped by more than one percent per year.

3. Potential Legal Liabilities

As we have reviewed, the industry is currently financially strong and viable. It is not,

however, without risk. The tobacco companies face one major business uncertainty: the potential for incurring substantial legal liabilities. This financial risk, which has been a characteristic of the industry for years, emanates from uncertainties related to litigation concerning the companies' business practices. Although the industry has lost only one lawsuit in its history, the risk of a major damages award creates uncertainty that must be factored into any assessment of financial prospects. The various expenses associated with settling and defending lawsuits also affect the profitability of the tobacco companies.

As stated earlier, the risks associated with potential legal liability have confronted this industry for many years. Litigation risks were endemic to the industry before any comprehensive tobacco legislation was ever contemplated, and they remain an independent source of business uncertainty notwithstanding the proposed legislation. Even in this environment, however, the combined stock market value of the tobacco companies has risen almost 50 percent in the last three years.

4. Proposed Legislation

I would like to now turn to the subject of comprehensive tobacco legislation and discuss some of the key features as contemplated.

Price Provisions

The central goal of proposed legislation is to lower youth smoking and the volume of cigarette sales in the United States. This goal is to be achieved in a variety of manners, including increasing the price of tobacco products. S. 1415, as reported out of the Commerce Committee,

requires cigarette manufacturers to make substantial payments to the Government, and mandates that the costs of such payments be passed through to consumers. As Deputy Secretary Summers has testified, the Administration estimates that the provisions will raise the price of cigarettes by $1.10 per pack, in constant dollars, by the year 2003, using pricing assumptions that ensure youth smoking targets will be met. Given other underlying trends in cigarette pricing, it is anticipated that the real price of cigarettes will rise to approximately $3.20.

Despite the size of the required payments, the proposed legislation contains three classes of provisions that protect the industry against a sharp drop in profitability. First, as noted, the legislation provides for consumers, not manufacturers, to finance the industry's payments. The pass-through provisions ensure that the payment costs do not come directly out of tobacco company profits.

Second, industry payments are allocated by market share, and adjusted for sales volumes declines after the fifth year. By taking into account individual companies' ability to pay, these mechanisms further ameliorate the effects on industry profitability. In addition, a number of proposals phase in the industry payments over five years. This allows the industry to adjust over time.

Third, both the original Attorney Generals' proposed settlement and S. 1415 contain a number of features that tend to maintain the market share of existing industry participants. For example, the legislation imposes costs not only on current market participants, but also on new entrants and importers.

Further Provisions

The Commerce Committee bill further attempts to reduce youth smoking through other means, such as restricting the access of youth to tobacco products, and restricting marketing to youth. It also imposes surcharges if the industry does not meet the youth-smoking reduction targets that the companies agreed to with the Attorneys General.

Legal Liability Provisions

Another central feature of comprehensive legislation is the legal liability protections that it provides to the industry. The comprehensive legislation would settle the 41 outstanding state suits against the industry, as well as a handful of local suits. The terms of the legislation also would apply to new entrants to the industry, and to international competitors. It thus resolves significant legal uncertainty, and provides broader coverage than merely settling currently outstanding legal claims. National legislation that covers all potential participants in the industry ensures that the industry is able to pass settlement costs on to consumers.

Comprehensive legislation also provides for limits on the industry's liability. Such limits further reduce the legal uncertainty facing this industry. The extent of the reduction in risk, however, depends on the details of the limits themselves.

5. Implications of Legislation for Bankruptcy Risk

I will now turn to the question of how comprehensive tobacco legislation will affect the tobacco industry's financial health. In summary, we do not believe that the proposed legislation will materially affect the tobacco companies' risk of insolvency. Even under conservative assumptions

with respect to price, domestic sales volume and operating margin, the tobacco industry will remain very profitable. The companies will continue to have earnings that are more than sufficient to cover interest payments. In short, bankruptcy in this industry is much more likely to arise from the vicissitudes of the market or of litigation than from comprehensive tobacco legislation.

The Effect of Price Increases on Sales Volume

Our analysis of the proposed legislation focuses on its effects on pricing, sales volume, and operating margins in the tobacco industry. As previously outlined, the proposed legislation contains several provisions that provide for the pass-through of payments to prices. The attendant price increases will lead to a decline in sales volume. We estimate that for every 10 percent increase in price, there is a 4.5 percent reduction in product demand. As a result, a $1.10 price increase, for example, would lower sales volumes by about 23 percent.

Some research analysts from Wall Street have predicted that the price increases caused by the proposed legislation will be greater than this analysis, and other legislation that has been proposed has contemplated greater price increases as well. If the price increase were higher, say $1.50, there would be a projected 30 percent decline in domestic cigarette volumes.

The Effect on Operating Earnings

Operating earnings are affected not only by reductions in sales volume, but also by declines in operating margins. As previously noted, the tobacco industry's cost structure is largely variable, allowing it to more readily adapt to changing environments. Thus, it is likely that the proposed legislation would cause the industry's margins to decline only modestly in the short run. Based upon

the relationship between sales volume and operating margin that currently exists within the industry, we estimate that a 23 percent decline in sales volume will lead to a decline in operating margins of approximately 15 percent. Under those circumstances, the combined effect of declining domestic sales and operating margins would lead to only a 12 percent decline in the total operating earnings of the industry. Accordingly, the tobacco companies would remain more profitable than American industry as a whole.

As noted earlier, some Wall Street research analysts project larger volume declines than 23 percent, and some proposed legislation contemplates larger volume declines as well. Even if that were the case, the domestic tobacco businesses of the various companies would remain profitable. Using margin assumptions more conservative than above, a 30 percent decline in volumes would lead to only a 15 percent decline in industry operating earnings. The industry would still have over $4 billion in domestic tobacco operating earnings and approximately $20 billion in overall operating earnings.

Corporate Debt Levels

The tobacco companies paid approximately $3 billion of interest payments last year on their outstanding debt. As noted, the industry had operating earnings of over $23 billion. Thus, the industry earned enough to cover its interest more than seven times. Indeed, all of the major participants in the tobacco industry have operating earnings from sources other than domestic tobacco -- such as international sales and non-tobacco products -- that far exceed annual interest payments. Thus, even with significant reductions in domestic tobacco earnings, these firms should be able to meet their interest obligations. Moreover, the asset values of the non-tobacco businesses

of Phillip Morris, RJR Nabisco, and Loews, are greater than the companies' outstanding debt. For instance, in the case of RJR Nabisco, the company's 80 percent stake in Nabisco is worth approximately $10 billion, while the company's outstanding debt (excluding Nabisco) is just over $5 billion.

6. Bond Market Investors

I now will discuss how bond investors assess the industry's credit risk. Bond investors are an important barometer, as they risk their money based on their assessment of potential risks and rewards. In addition, they are not easily swayed by politics, rhetoric or theory.

By way of background, corporate bonds trade at yields that are higher than the Treasury's borrowing rate. This interest rate differential is due to many factors, but is primarily associated with the risk of corporate default. Investors refer to this interest rate differential as a "credit spread." The greater the "spread" above Treasuries, the greater the credit risk associated with the company.

In addition to assessing the risk of companies in relation to the Treasury, investors also make judgments about the risk of companies in relation to each other. Investors assess the relative risks of corporate bonds in terms of maturities and company-specific risks. The yield that investors demand on a particular firm's bonds reflects what investors believe to be the credit risk of the firm. Investors generally demand a higher yield if they perceive that the credit risk is more significant. Conversely, they will accept a lower yield if they believe that the credit is safer. Thus, the yield demanded by investors for a particular bond will change as perceptions about the company's creditworthiness change.

Figure C illustrates how bond investors assessed the credit risk of the tobacco companies at

three points in time. We looked at trading levels (i) prior to the Attorney Generals' proposed settlement, (ii) just after the Attorney Generals' proposed settlement, and (iii) during the several days after the Commerce Committee voted S. 1415 out of committee. The numbers in the columns represent the additional yield that investors required to buy the tobacco companies' bonds (relative to an index of other relevant corporate bonds). Where investors demanded higher yields, they perceived higher levels of risk.

A number of important observations can be made from this information. First, investors viewed the credit risk for all of the companies in early April 1998 as about the same as they did one year earlier. This is evidenced by the fact that the additional yield required by investors did not changed materially. In fact, investors were willing to purchase the industry's bonds at modestly lower yields than prior to the Attorney Generals' proposed settlement. Accordingly, S. 1415 does not appear to have had any negative effect on investor perceptions of the tobacco companies' credit risk. If anything, these firms are now viewed by investors as slightly safer than they were one year ago.

Second, after the Attorney Generals' proposed settlement, the bonds of one of the companies, RJR, improved significantly. This suggests that investors saw the Attorney Generals' proposed settlement as lowering the credit risk for this company. That yield advantage was reversed as the enactment of the June 20 settlement became less likely. But, to reemphasize, in the wake of the Commerce Committee vote, the market's assessment of the bankruptcy risk of RJR, as well as the other tobacco companies, was no different than it was before discussions of comprehensive tobacco legislation were made public. The risk was, and remains, low.

Third, the interest rates required on the debt of all but one firm in this industry are very close

to those required on the most financially secure businesses in America. The one company for which investors require an additional premium, RJR, has greater levels of debt. This is primarily due to the debt left over from RJR's leveraged buy-out completed in 1989. To give you some context, however, even RJR, which is the riskiest of the tobacco companies, has a yield that is similar to well-known companies such as Westinghouse and K-Mart.

7. Conclusion

In conclusion, the tobacco industry is financially strong and viable. Comprehensive tobacco legislation includes mechanisms to protect that financial condition. The legislation assures that payments are made by consumers rather than the tobacco manufacturers, and makes adjustments according to individual companies' ability to pay. The industry has substantial operating earnings to bear any decline in earnings due to price increases caused by the legislation. The industry also has significant non-tobacco assets that are currently valued well in excess of their debt. As previously noted, tobacco companies for years have faced substantial legal uncertainties related to their business practices. Comprehensive tobacco legislation does not increase these existing risks. Lastly, S. 1415 does not appear to have any material effect on bond investors' perceptions of the tobacco companies' credit risk.

While there are commercial risks facing the tobacco companies, as there are facing all companies, we do not see any reason to expect that the pricing effects of comprehensive tobacco legislation would materially affect these companies' risk of insolvency. They should be able to continue to operate profitably in the United States and abroad.

Tob-sct-bankruptcy

WILL TOBACCO COMPANIES GO BANKRUPT UNDER PENDING NATIONAL LEGISLATION?

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WILL TOBACCO COMPANIES GO BANKRUPT WITH PROPOSED NATIONAL LEGISLATION?

In short, not likely. It is impractical, and certainly won't solve all of their problems. Bankruptcy is more of a threat to coerce Congress into stalling or killing effective, comprehensive national tobacco control legislation. An objective review of currently pending tobacco control legislation in Congress reveals the risk of bankruptcy for any tobacco company is a remote one. The report, commissioned by the American Cancer Society, provides a factual examination of the potential risks of bankruptcy to U.S. tobacco companies based on legal and economic considerations.

LEGAL AND ECONOMIC ANALYSIS OF S. 1415 - David Sweanor, JD

If tobacco companies go bankrupt, it will be because they continue to sell tobacco products to kids.

The risk of bankruptcy to tobacco manufacturers due to the proposed legislation is remote. Required payments are basically a specified tax, and history has shown the industry is quite capable of dealing with such taxes. The risk of serious financial consequences to any particular tobacco company would only occur if the company continually failed to meet youth smoking reduction targets, in which case tobacco companies would be choosing to jeopardize their own existence.

ECONOMIC ANALYSIS OF S.1415 - Jeffrey Harris, MD, PhD

Tobacco companies will loose profits under S. 1415, but not enough to force them to file bankruptcy.

Under S. 1415, also known as the McCain bill, total U.S. cigarette consumption and manufacturers' real profits on domestic sales of cigarettes will decline by 21.3 percent. Without federal intervention, profits will decline by only 12.4 percent. This analysis does not predict financial insolvency for the tobacco industry. The industry as a whole – as well as individual firms – will lose money but remain profitable because of more than $7.2 billion in domestic profits each year.

LEGAL REASONS WHY BANKRUPTCY IS IMPRACTICAL - Edward C. Dolan, JD

As long as tobacco companies continue to sell their products -- as they will because tobacco products are extremely profitable -- filing bankruptcy will not solve their problems.

Although business reorganizations under the federal bankruptcy laws are commonplace, nothing in S. 1415 would make filing for bankruptcy either necessary or inevitable. Not only would bankruptcy not be necessary, but it would not solve the problems the industry is facing now or in the future -- with or without federal legislation. So long as the tobacco companies continue to manufacture, market and sell their products, new liabilities for damage to the health of individuals who use their addictive products will continue to accumulate.

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Summary

The McCain Bill: A Look at the Potential for Bankruptcy of Existing Tobacco Manufacturers

by David Sweanor, JD

Introduction

The risk of bankruptcy to tobacco manufacturers due to the proposed legislation is remote, based upon the fact that required payments are basically a specified tax, and the industry has shown itself to be quite capable of dealing with such taxes. It appears that the risk of serious financial consequences to any particular tobacco company would only occur if egregious behavior were to continue in which case tobacco companies are choosing to jeopardize their existence.

The National Tobacco Settlement Trust Fund

Under the legislation, tobacco companies are required to make an initial payment into a trust fund of $10 billion. The total cost of these payments amounts to about 40 cents a pack based on the 24 billion packs sold in 1997, and the fact that 3.2% of the total payment is coming from the manufacturers of smokeless tobacco. The financially weaker companies are allowed to pay a proportionately lower share of the total.

Tobacco companies would also make subsequent annual payments ($14.4 billion for 5 years, increasing to $23.6 billion each year afterwards) to the Fund for a period of 25 years. The payments are treated like a tax in that they are required to be passed through to consumers and the companies are allowed to write off the cost of the payments. This gives greater protection to any financially weaker manufacturers. The base amounts are increased annually to reflect inflation, yet the payments are not adjusted to reflect volume declines until 2005. Until then any declines in consumption will result in higher prices for the remaining market.

It is possible to look at all of the price increases required by the McCain bill, and allow for further manufacturers' price increases as well as further tax increases by state and federal governments. One estimate was presented by Martin Feldman, a tobacco industry analyst with Salomon Smith Barney. He estimated that the average retail price would climb to $4.00 by 2006 and to $4.36 by 2009. Total industry volumes were forecast to decline to 385 billion cigarettes (from the current 480 billion) during this time. Would prices at $4.00 a pack and total volume declines of 20% over a decade devastate the industry? A volume decline of 20% during the next 11 years would not be extraordinary. In fact domestic consumption has fallen by the same percentage amount in the past 12 years. Also, a cigarette price of $4.00 per pack is not uncommon by the standards of wealthy countries and tobacco companies continue to do business in these countries.

The Tobacco Community Revitalization Trust Fund

Tobacco companies would also make payments to a fund for the purpose of financially assisting tobacco dependent communities. The total payments by the manufacturers will be $2.1 billion per year from 1999 through 2008 and $500 million from 2009 through 2023. The much smaller amounts going to this trust fund, combined with the allocation of the amounts by market share,

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effectively treats this as simply another tax. It is likely to add less than 10 cents a pack to cigarette prices, and it declines significantly after ten years.

The Look-Back Assessment

The McCain bill specifies penalties for failure to achieve reductions in tobacco use among youth. These penalties work quite differently from the assessments required for the previously examined trust funds. The allocation, though based on market share, can be redistributed as a result of a court action brought by one manufacturer against one or more others and could give a relative disadvantage to one or more companies. Also, the payments required pursuant to this section are not deductions for income tax purposes.

The net result is that the 'Look Back' provisions, under most scenarios, would not precipitate bankruptcy. The one possible exception would be if a financially weak tobacco company grabbed a significant share of a largely undiminished youth market, and was then subjected to the range of possible penalties. But in that case bankruptcy would be a foreseeable result of malfeasance, and it is more likely that the threat of these penalties would have caused a change in corporate behavior.

Civil Liability of Manufacturers of Tobacco Products

The McCain bill caps aggregate payments at $6.5 billion. Payment of this amount is not a certainty, since the companies may successfully defend themselves from future actions. If, on the other hand, cases against the tobacco companies were largely successful, the $6.5 billion annual cap comes into play. If all of these payments were made according to market share there would be little reason for an increased risk of industry bankruptcies.

The bigger threat to the financial viability of one or more tobacco companies would be if future awards were significantly different from market share. Even if one company is singled out for punishment it would be as a result of particular malfeasance. As with the 'look back' provisions on sales to young people, this part of the bill would be a threat to financial viability, but is apparently designed with this in mind.

The Risk from Non-Participating Manufacturers

The McCain bill imposes a fee on any non-participating manufacturer. In addition a non-participating company must pay a deposit equal to 150% of the fee to cover liability payments, and any amounts not so used cannot be reclaimed for 35 years. The overall effect of these provisions is to eliminate a competitive threat from non-participating manufacturers.

Conclusion

The risk of bankruptcy due to the trust fund payments is remote, based upon the fact that these payments are basically a specified tax, and the industry has been shown to be quite capable of accommodating such taxes. The risk associated with potentially differentiated payments pursuant to the look back provisions and civil liability provisions is greater, but would be a result of unequal malfeasance on the part of the manufacturers.

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Summary

Price of Cigarettes and Profits of Cigarette Manufacturers With and Without Federal Intervention, 1997–2006

by Jeffrey Harris, MD, PhD

Introduction

This report assesses the impact of proposed Congressional legislation on the future price of cigarettes and the profits of the domestic tobacco-producing divisions of U.S. cigarette manufacturers. Prices and profits during the years 1997–2006 are estimated under two different scenarios: (a) enactment during 1998 of legislation substantially identical to the proposed National Tobacco Policy and Youth Smoking Reduction Act (S. 1415); and (b) no significant Federal legislation through 2006. The impact of Congressional legislation is the difference between these two scenarios.

This analysis does not predict financial insolvency for the U.S. domestic tobacco industry. The industry as a whole – as well as individual firms – will lose money but remain profitable.

Cigarette Manufacturers Have Passed Through Their Recent Settlement Costs To Consumers in the Form of Higher Prices.

Total 1997 settlement payouts of $896.8 million to Mississippi, Florida and *Broin* flight attendants cases resulted in an increase of 3.7 cents per pack (that is, $896.8 million divided by 24 billion packs sold). As of April of this year, cumulative payments for 1997-1998 equaled $1.712 billion due to the Texas case; this resulted in an overall increase of 10.9 cents per pack.

Other Components of the Retail Price of Cigarettes, Including State Excise and Sales Taxes and Wholesaler and Retailer Markups, Have Not Risen Sharply.

The nominal (not adjusted to inflation) average retail price of cigarettes increased from $1.92 per pack in 1994 to $2.02 per pack in 1996, which corresponded to a rate of increase just under the overall growth in the consumer price index (CPI). By contrast, the average retail price rose to $2.12 in 1997. State and local excise taxes increased at a real rate of 1.0 percent annually during 1994–1996 and 1.3 percent annually during 1996–1997. State sales taxes actually declined when measured as a percentage of the pre-tax price. The Federal excise tax remained constant in nominal terms but declined in real terms.

If one subtracts all Federal, state and local taxes from the retail price, one is left with the revenues to manufacturers, wholesalers and retailers. During 1994–1996, this quantity rose at about the same rate as the CPI. The data clearly show that wholesale/retail margins have been declining in real terms. The only significant component of recent price increases is manufacturers' wholesale prices.

These results contradict the hypothesis that increases in manufacturers' wholesale prices resulting from settlement costs somehow cause other components of price to rise in tandem. With the exception of state excise taxes, which have been rising at about a 1-percent annual real rate, the other components of price – Federal excise taxes, state sales taxes, and wholesaler/retailer markups – have not kept pace with inflation.

S. 1415 Will Result in a Real Retail Cigarette Price Per Pack in 2003–2004 That is 85 Cents Higher Than the Expected Price Without Federal Intervention. By 2005–2006, the Effect of S. 1415 is 55 Cents Higher.

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Summary

Under S. 1415, the real price rises progressively to $3.38 in 2003–2004 as the required payments of the Act escalate. The real price then falls to $3.07 per pack by 2006 as a result of the volume adjustment provision that takes effect in 2005. Without significant Federal intervention, the real price continues to rise to $2.54 in 2003, as manufacturers settle with an increasing proportion of states and pass on the cost of these losses to consumers. Once all state settlements are in place by 2003, real price then declines slightly to $2.52 by 2006 as a result of the volume-adjustment provisions of the state settlement agreements.

The analysis of the impact of S. 1415 does not include the effect on price of any additional "look-back assessments" imposed on cigarette manufacturers for failing to meet underage smoking targets. If manufacturers failed to meet such targets, then the real price of cigarettes could rise up to an additional 15 cents per pack.

If the tobacco industry were to enter into nationwide settlement agreements with Blue Cross/Blue Shield plans similar to that of Minnesota, then the preliminary estimate is that cigarette prices would gradually rise by an additional 20 cents per pack through 2003, but fall toward zero by 2008 as manufacturers completed their scheduled payments. These additional effects on cigarette prices would apply to both S. 1415 and the no-intervention case.

Under S. 1415, Total U.S. Cigarette Consumption and Manufacturers' Real Profits on Domestic Sales of Cigarettes Will Decline by 21.3 Percent. If There Were No Federal Intervention, Total U.S. Consumption and Manufacturers' Real Domestic Profits Will Decline by 12.4 Percent.

Under enactment of S.1415, consumption will decline from 24 to 18 billion packs during 1997 through 2004, but will then rebound under the current volume-adjustment provision. By contrast, consumption under the no-intervention scenario will decline from 24 to 21 billion packs by 2006. So long as manufacturers can pass their costs on to consumers and thus retain a 30-cent-per-pack operating margin, domestic cigarette profits will follow consumption. Under S.1415, real operating profits will fall by $1.8 billion during 1997–2003 and then rise by $0.3 billion during 2003–2006. Under a no-intervention scenario, real profits will fall by $0.9 billion during 1997–2003. By 2003, enactment of S.1415 would result in about a $1 billion loss in real profit compared to a scenario in which tobacco manufacturers continued to settle cases on their own.

Discussion and Conclusions

The analysis of the provisions of S. 1415 indicates the peak effect of the proposed legislation will occur during 2003–2004. Starting in 2005, the volume-adjustment provision will substantially reduce required payments by participating manufacturers. At its peak impact in 2003–2004, S. 1415 will raise the real price of a pack of cigarettes by 85 cents in comparison to the case where there is no significant intervention. At its peak impact in 2003–2004, S. 1415 will cause total cigarette consumption to decline by an additional 3.2 billion packs in comparison to the base case. The Act will also cause manufacturers' real annual pre-tax operating profits to decline by $1 billion in comparison to the no-intervention scenario.

By 2006, S. 1415 will raise the real price of cigarettes by 55 cents in comparison to the no-intervention case. At that time, the Act will result in a decline in annual cigarette consumption by 2.1 billion packs more than the base case. It will also cause manufacturers' real pre-tax operating profits to decline by $0.6 billion per year in comparison to the no-intervention scenario.

This analysis does not predict financial insolvency for the U.S. domestic tobacco industry. The industry as a whole – as well as individual firms – will lose money but remain profitable.

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The Recent Threat of Bankruptcy Filings By Tobacco Companies in Response to Pending National Legislation

May 13, 1998

by Edward C. Dolan
Hogan & Hartson L.L.P.
Washington, D. C.

In response to pending national legislation, the tobacco companies have claimed, among other things, that enactment of the proposed bills might bankrupt the tobacco industry. The truth is that, although business reorganizations under the federal bankruptcy laws (Title 11 of the United States Code, hereafter the "Bankruptcy Code") are not infrequent occurrences, nothing in the proposed legislation would make a bankruptcy filing by one or more of the tobacco companies either necessary or inevitable.

Not only would a bankruptcy filing not be necessary, but it would provide the filing company with only an incomplete answer to continuing liability. The Bankruptcy Code is well designed to protect the interests of existing claimants while allowing companies an opportunity to reorganize their affairs. The Bankruptcy Code does not and cannot discharge, limit or address the liability of a filing company for post-bankruptcy actions. So long as the tobacco companies continue to manufacture, market and sell their products, new liabilities for damaging the health of individuals who use those products will continue to accrue.

Lastly, there would be very real disincentives for a tobacco company to file a bankruptcy. A bankruptcy filing would place a tobacco company and all of its assets and affairs under the jurisdiction of a federal court with broad equitable powers. This court would have the power to enforce the rights of creditors and other interested parties to investigate, review and be heard on issues touching virtually every aspect of the company's business. A tobacco company bankruptcy might give its creditors an effective forum in which to convincingly argue for the termination of the company's business and the complete liquidation of its assets. A tobacco company bankruptcy, because it would automatically stay actions against the company outside of the bankruptcy court, would also serve to focus the attention and energies of civil litigants on corporate parents and other affiliates of the tobacco company, a trend in recent court actions.

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THE McCAIN BILL

A Look at the Potential for Bankruptcy of Existing Tobacco Manufacturers

David Sweanor
Tobacco Control Consultant
and Senior Legal Counsel, Smoking and Health Action Foundation, Ottawa, Ontario.

April, 1998

INTRODUCTION

This paper seeks to review the McCain bill to provide insights on the potential of such legislation causing the bankruptcy of existing tobacco companies. In doing so it seeks to concentrate on the economics of the provisions in the bill, and draws upon information from the companies themselves as well as price elasticity analyses and international experience.

This analysis focuses on the cigarette manufacturers, though its conclusions are felt to be applicable to the manufacturers of smokeless tobacco. It also does not delve into the risk of 'tactical' bankruptcy, that is, the use of bankruptcy law to seek to gain some tactical advantage.

In general it appears that the risk of bankruptcy for financial reasons is slight, with the possible exceptions of potential company-specific penalties for sales to children and product liability awards.

In reviewing the bill this paper looks at the trust fund payments for the national settlement, the payments required to fund activities in the tobacco-producing sector, the penalties for sales to children, the civil liability of the manufacturers, and the role of non-participating manufacturers.

1) THE NATIONAL TOBACCO SETTLEMENT TRUST FUND

The largest sums of money payable by the tobacco companies would be pursuant to Title IV, which specifies payments in Sec. 402.

THE INITIAL PAYMENT

Sec. 402(a)(1) specifies that the participating manufacturers would make an initial payment of $10 billion dollars, and specifies the allocation of this expense among the companies. The allocation does not match market shares. Specifically, Philip Morris would be paying significantly more than its proportional share of the market and RJR would be paying significantly less. Liggett would not be required to make a payment.

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The required payments can be compared to domestic cigarette market share by looking at first 9 months market shares in 1997, obtained from the Philip Morris Companies Inc. third quarter 1997 Financial Fact Sheet. The results are as follows:

COMPANY	MARKET SHARE	PAYMENT ALLOCATION
Philip Morris	49.1%	65.8%
RJR	24.2%	6.6%
B&W	16.1%	17.3%
Lorillard	8.7%	7.1%
Other	1.9%	0.0%

This is a 'one off' payment and appears to be a reiteration of what the companies earlier agreed to. The relative advantage given to RJR and Liggett does not appear to place the other companies, and particularly Philip Morris, at any company-threatening disadvantage. My reasons for this conclusion are as follows:

- 1) It is the financially weaker companies that are being allowed to pay a proportionately lower share of the total. As such, these companies would get a cost advantage, rather than be placed in risk of bankruptcy.

- 2) The total cost of the payments amounts to about 40 cents a pack based on the 24 billion packs sold in 1997, and the fact that 3.2% of the total payment is coming from the manufacturers of smokeless tobacco (Sec. 402(a)(1)(E)). Even if amortized over a single year, and offset through price increases, this would not give any significant marketplace disadvantage to any economically weak company. In fact the payment structure specifically supports the weaker companies.

- 3) The McCain bill simply reiterates something that the companies apparently agreed to in the June 20, 1997 agreement with the Attorneys General. In the 10-Q filing made to the Securities and Exchange Commission by RJR Nabisco Holdings Corp. for the period ending June 30, 1997 it was stated (at page 10, and reiterated at page 64 of the 1997 Annual Report) that the company "believes its share of the initial payment will be in the range of $600 to $700 million". In the Philip Morris 10 Q filing for the period ending September 30, 1997 it was stated (page 25) that the company "currently estimates that its share of the initial Industry Payment would be approximately $6.6 billion." The Loews Corporation 1997 Annual Report states, at pages 18 and 76 that Lorillard's estimated payment would be approximately $750 million. The previous acceptance of these payment terms indicates that the companies themselves do not see these differentiated payments as a threat to their financial viability.

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THE ANNUAL PAYMENTS

Sec. 402 (b) specifies annual payments by the participating manufacturers, beginning one year after the date of enactment of the Act. These start at $14.4 billion and reach $23.6 billion for the fifth and subsequent years.

These payments are based upon actual domestic market share (Sec. 402(e)). The payments are also required to be passed through to consumers (Sec. 402(G)). As a result these payment requirements operate very much like the imposition of a specific excise tax. In fact the existence of a legislated duty to pass on the cost to consumers gives even greater protection to any financially weaker manufacturers. It is always possible for a manufacturer to absorb all or part of an excise tax increase, but they cannot absorb any part of this cost.

Since Sec. 402(b) is acting like a tax, with no ability on the part of the manufacturers to absorb it, the only question is whether the elevated prices will, themselves, force bankruptcy. Sec. 405 reinforces the treatment of these payments as being like a tax, since it allows the companies to write off the cost of the payments.

As this is an increased fixed cost applied to all cigarettes there is no relative advantage given in cigarette pricing among the participating manufacturers. In addition, the requirement of a significantly higher fixed cost would mask differences in operational efficiencies of different companies. For instance, if it costs RJR an additional 10 cents per pack to make and market cigarettes, the relative disadvantage in the marketplace becomes less when the base price becomes higher. At a dollar a pack the difference is noticeable, but at three dollars becomes less pronounced. So the higher taxes, if anything, could be protective of financially weaker companies.

Since there is no reason the payment terms should undermine the weaker companies the only question is whether the payment amounts would do so. This would be the case if the total increase in price led to a such a massive reduction in tobacco sales that some participating manufacturers found the market no longer viable. In looking at the impact on prices the Sec. 403 "adjustments" must be taken into account. The key provisions are as follows:

1) Sec. 403(a)(1): The base amounts are increased annually to reflect inflation, or three percent, whichever is greater. This will prevent the erosion in payments in the face of inflation, and is not an unusual technique by governments.

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2) Sec. 403(a)(2): The payments are not adjusted to reflect volume declines until 2005. Until then any declines in consumption will result in higher prices for the remaining market. This could greatly escalate prices if there is a precipitous decline in domestic tobacco use.

3) Sec. 403(a)(2)(b): There will be a credit given equal to 80% of each company's payments pursuant to tort liability. This not only reduces potential liability, but gives protection to companies which might otherwise be placed at a competitive disadvantage due to courts' perception of past behavior. This actually gives greater protection from bankruptcy than is customarily found in other industries, since it protects those who could be disproportionately responsible for past malfeasance.

Of these provisions, the possibility of rapid increases in price prior to 2005 would be the greatest concern to the manufacturers. Price affects overall consumption, and any decline in consumption is reflected in higher prices as the required payments are spread among fewer packages of cigarettes.

Whether price alone would force tobacco companies into bankruptcy requires an estimate of consumption trends prior to 2005, when volume declines would reduce the base payment amount (Sec. 403(a)(2)). Assuming annual payments commenced in 1999 (meaning the initial payment was made later this year) declines in volume would not be offset by a decline in the base amount of payments for five years. As such, the total of $23.6 billion would have to be raised from whatever tobacco products were being sold by 2004.

Determining the overall decline in consumption based upon all of the measures anticipated in the McCain bill is an inexact science. looking simply at the provisions in Sec. 402, it is possible to estimate the declines in sales, and increases in package prices, based upon a -0.4 price elasticity. Quick calculations indicate that the biggest price increase occurs on the implementation of the program, which, with the lack of adjustment for decreasing volumes, amounts to a price increase of about 56 cents a pack and a decrease in sales of just over 11%. The further price increases and volume declines prior to 2005 amount to a total 'tax' increase of about $1.06, and a total decline in sales of roughly 18%.

It is also possible to look at all of the price increases required by the McCain bill, and allow for further manufacturers' price increases, further tax increases by state and federal governments. One estimate was presented by Martin Feldman, a tobacco industry analyst with Salomon Smith Barney, in testimony before the Senate Commerce Committee (where the McCain bill was being examined) on March 19, 1998. It was Feldman's estimate that the average retail price would climb to $4.00 by 2006 and to $4.36 by 2009. This takes into account anticipated further tax increases and margin increases by the tobacco trade. Total industry volumes were forecast to decline to 385 billion cigarettes (from the current 480 billion) during this time. Feldman's analysis, as he stated before the same committee on March

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24, gives higher prices than those determined by the Treasury, but can be used for the purpose of illustration.

Would prices at $4.00 a pack and total volume declines of 20% over a decade devastate the industry? The answer appears to be a clear 'no'. A volume decline of 20% during the next 11 years would not be extraordinary. In fact domestic consumption fell by the same percentage amount in the past 12 years. In terms of the actual reduction in cigarettes consumed Feldman's analysis points to a reduction of 95 billion per year by the tenth year of the proposed legislation. By contrast the reduction has been 101 billion per year in the past 10 years.

A cigarette price of $4.00 per pack is not extraordinary by the standards of wealthy countries. Many countries (including the United Kingdom, Australia, Ireland, Sweden, Norway, Denmark, Finland, and parts of Canada) already have prices above this level.

While some companies might exit the tobacco business for other reasons, there is no reason to believe that the payments required to be made to the National Tobacco Settlement Trust Fund would force any of the participating manufacturers into bankruptcy.

2) THE TOBACCO COMMUNITY REVITALIZATION TRUST FUND

Sec. 1011 establishes an additional trust fund, paid for by the participating manufacturers, for the purpose of financially assisting tobacco dependent communities. The amounts required cannot exceed $1.65 billion per year for lost tobacco quota (Sec. 1011(d)(1)), and for community economic development grants (Sec. 1011(d)(3)) cannot exceed $375 million per year from 1999 through 2008, or $450 million per year from 2009 through 2023.

In addition Sec. 1011(d)(4) and (5) provide for payments to tobacco worker transition programs and farmer opportunity grants. The combination of these payments are not set to ever exceed $100 million per year.

In total, Sec. 1012 specifies (Sec. 1012(c)(2)) that the total payments by the manufacturers will be $2.1 billion per year from 1999 through 2008 and $500 million from 2009 through 2023.

These payments are based upon domestic market share (Sec. 1012(d)). The much smaller amounts going to this trust fund, combined with the allocation of the amounts by market share, effectively treats this as simply another tax. It is likely to add less than 10 cents a pack to cigarette prices, and it declines significantly after ten years.

No manufacturer is treated differently from any other manufacturer and the price increases are already factored in to the previously discussed analysis by Martin Feldman.

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3) THE LOOK-BACK ASSESSMENT

Sec. 202 of the McCain bill specifies penalties for failure to achieve reductions in tobacco use among youth, as specified in Sec. 201. These penalties work quite differently from the assessments required for the previously examined trust funds. The most important differences, when examining the possible impact on the financial viability of tobacco companies are as follow:

1) The allocation, though based on market share (Sec. 402(c)(1)), can be redistributed as a result of a court action brought by one manufacturer against one or more others (Sec. 402(f)). As a result the penalties could be levied unequally, giving a relative disadvantage to one or more companies.

2) The payments required pursuant to this section are not deductions for income tax purposes (Sec. 402(e)). This could lead to different treatment if there are different effective tax rates among the companies. It also accentuates the impact of any unequal distribution of any penalty, since the price increase would have to be significantly higher to have enough money left after provision for income taxes to pay the fine. For instance, if a company were required to pay $200 million, but had profits taxed at 40%, it would have to raise prices by enough to obtain $333 million in pre-tax profits in order to have that non-deductible $200 million left after taxes.

3) If the industry (Sec. 202(b)(3)) or a company (Sec. 203(d)) has a substantial non-attainment of the required reductions in underage tobacco use, the $3.5 billion annual cap on payments (Sec. 202(b)(3)) and the limits on tort liability (Sec. 203(d)) do not apply. This could lead to significantly increased payments and, in the case of removed caps on liability payments, would potentially threaten the financial viability of existing tobacco companies.

The impact of these provisions could have different impacts on different companies, which raises the possibility of a significant competitive disadvantage for one or more existing companies. The different levels of payment, to the extent they exist because of different shares of the youth market, are operating as a true disincentive to sell tobacco products to children. To apply the payments simply on the basis of adult market share would be unfair if all companies are not equally guilty. This provision now applies much like penalties businesses can face for pollution, or any of a wide range of other disapproved actions.

To the extent these penalties are seen as a potential threat to the viability of tobacco companies, they are doing what they are designed to do. If a company achieved a huge market among teenagers it could be put at serious financial risk, including, potentially, bankruptcy. Yet this appears to be exactly the effect the drafters are seeking to achieve, and it is based on solid public policy grounds.

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But these provisions need not cause the collapse of any tobacco company. If the specified reductions in youth smoking occur there simply is no payment necessary, and the industry is not affected. If the provisions are missed just slightly the payments are minor, and cannot take place until at least year 3 of the legislation.

The overall payments, barring overwhelming lack of success in reducing youth tobacco use, are capped at $3.5 billion per year (Sec. 202(b)(3)). Even at this level, which could not reasonably be achieved until the second half of the first decade of operation of the legislation, the total cost would amount to something in the range of less than 20 cents a pack (assuming diminished annual sales of less than 20 billion packs a year by that time). This would have the impact of slightly reducing tobacco sales, but would not significantly harm the overall viability of the industry.

The net result is that the 'Look Back' provisions, under most scenarios, would not precipitate bankruptcy. The one possible exception would be if a financially weak tobacco company grabbed a very large share of a largely undiminished youth market, and was then subjected to the range of possible penalties. But in that case bankruptcy would be a foreseeable result of malfeasance, and it is much more likely that the threat of these penalties would have caused a change in corporate behavior in time to avert disaster.

CIVIL LIABILITY OF MANUFACTURERS OF TOBACCO PRODUCTS

Title VII of the McCain bill specifies the scope of liability of tobacco companies from future litigation.

Sec. 706(c) caps aggregate payments at $6.5 billion. The payment of this amount is not a certainty, since the companies may successfully defend themselves from future actions. To the extent that future liability payments will not fall proportionately on all companies each company has an incentive to fight future actions. This incentive of each company to fight could reduce the likelihood of success of actions taken against these companies.

If, on the other hand, cases against the tobacco companies were largely successful, the $6.5 billion annual cap comes into play. If all of these payments were made according to market share (ie. all the companies were similarly guilty and were found to be liable for amounts roughly aligning with market shares) there would be little reason for an increased risk of industry bankruptcies.

In effect this would simply be operating like a tax, in that it would equally raise the cost of business for all participants. Over time the price per pack could also be expected to be forced upward by the fact that the cap remains constant even if overall sales are declining. The $6.5 amounts to about 27 cents a pack at current consumption levels, but would represent about 34 cents a pack by 2009 if Martin Feldman's analysis for

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Salomon Smith Barney prove to be accurate. The slight increase in per pack costs would slightly reduce aggregate demand, but not by enough to imperil the financial viability of manufacturers.

The bigger threat to the financial viability of one or more tobacco companies would be if future awards were significantly different from market share. If, for instance, a small company such as Lorillard was held responsible for 90% of the total cap, it would be effectively priced out of the market and would most likely become insolvent.

Such a wide discrepancy in liability does not appear likely at this time. A reading of tobacco company annual reports and Securities and Exchange Commission filings shows that all of the companies are defendants in a very large number of legal actions. Even if one company is singled out for punishment it would be as a result of particular malfeasance. As with the 'look back' provisions on sales to young people, this part of the bill would be a threat to financial viability, but is apparently designed with this in mind.

THE FINANCIAL RESOURCES OF THE TOBACCO COMPANIES

Any discussion of the risk of bankruptcy of existing tobacco companies needs to consider the financial condition of these companies. As shown in a review of the available information on Philip Morris, RJR, Loews/Lorillard and Brown & Williamson/BAT Industries, these companies are extremely good at generating cash flow.

Cigarettes are manufactured for a cost of around $2.00 a carton (personal communication) and sold to wholesales (net of tax) for an average of close to $9.00. This allows the companies vast profit margins, and leaves significant room to reduce costs. In fact the McCain bill would require a reduction in many large current marketing expenses.

If a company were to become financially unviable, it is likely due to reasons such as too great a level of debt compared to equity (leverage). In such a case the tobacco business would still be viable, but may be reorganized. Significantly, the McCain bill (Sec. 706(d)) specifies that no participating manufacturer shall cease operations without establishing a surviving entity against which a tobacco claim may be brought.

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THE RISK FROM NON-PARTICIPATING MANUFACTURERS

The provisions of the McCain bill, overall, do not appear to unduly increase the risk of insolvency of any participating manufacturer. The largest risks, as has been discussed, are tied to malfeasance in the areas of product liability and tobacco sales to young people. Yet this still leaves the question of the role of another entity that sought to enter the U.S. domestic tobacco market. Any company not responsible for all of the past harm might be lured by the chance of a marketing advantage conferred by all of the payments the domestic companies are being forced to make.

Any such hope would be short-lived. Sec. 708 imposes a fee on any non participating manufacturer. The fee is specified (Sec. 708(b)(2)(A)) as being equal to the fees being paid under the Act by the participating manufacturers. In addition a non-participating company must pay a deposit equal to 150% of the that fee (Sec. 708(c)) to cover liability payments, and any amounts not so used cannot be reclaimed for 35 years. The overall effect of these provisions is to eliminate a competitive threat from non-participating manufacturers.

CONCLUSION

The risk of bankruptcy due to the trust fund payments is remote, based upon the fact that these payments are basically a specified tax, and the industry has been shown to be quite capable of dealing with such taxes. The risk associated with potentially differentiated payments pursuant to the look back provisions and civil liability provisions is greater, but would be a result of unequal malfeasance on the part of the manufacturers. The risk of non-participating manufacturers driving existing players out of the market through use of a pricing advantage is non-existent due to the costs imposed on any non-participating manufacturer.

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THE PRICE OF CIGARETTES AND THE PROFITS OF CIGARETTE MANUFACTURERS WITH AND WITHOUT FEDERAL INTERVENTION, 1997–2006

A Report to the American Cancer Society

Jeffrey E. Harris MD PhD[1]
May 11, 1998

Introduction

This report assesses the impact of proposed Congressional legislation on the future price of cigarettes and the profits of the domestic tobacco-producing divisions of U.S. cigarette manufacturers. I estimate prices and profits during the years 1997–2006 under two different scenarios: (a) enactment during 1998 of legislation substantially identical to the proposed National Tobacco Policy and Youth Smoking Reduction Act (S. 1415 Version RS, May 1, 1998);[2] and (b) no significant Federal legislation through 2006. The impact of Congressional legislation is the difference between these two scenarios.

To determine the effect of S. 1415 or any other bill, we need to recognize that cigarette prices will continue to rise even if no Federal statute is passed.[3] State governments will continue to raise cigarette excise taxes. Wholesalers and retailers will continue to adjust cigarette price markups to reflect their rising costs. Most important, cigarette manufacturers will continue to raise their prices in order to cover the costs of settling law suits. In 1997, as discussed below, U.S. cigarette manufacturers made settlement payments equal to approximately 4 cents per pack

[1] The opinions expressed in this report are the author's sole responsibility. They do not necessarily reflect the opinions of the American Cancer Society, the Massachusetts Institute of Technology, or the Massachusetts General Hospital.

[2] Internet: http://thomas.loc.gov/cgi-bin/query/C?c105:./temp/~c1058qN43q

[3] Other analysts have attempted to predict how proposed Congressional legislation will affect future cigarette prices. See, for example, *Statements of Martin Feldman, Salomon Smith Barney, Before the Senate Commerce Committee*, March 19, 1998 and March 24, 1998; *Statement of Treasury Deputy Secretary Lawrence H. Summers, Senate Committee on Commerce, Science and Transportation*, March 24, 1998; *Statement of David J. Adelman, Tobacco Industry Analyst - Morgan Stanley Dean Witter, Before the Senate Judiciary Committee*, April 30, 1998. Unfortunately, their predictions of the rise in cigarette prices have often been misinterpreted as entirely the result of Federal intervention. What matter is not the absolute rise in price from its current level, but the additional increase in price, if any, that would result from Federal intervention.

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of cigarettes sold. These increased costs have already passed on to their customers.

U.S. cigarette manufacturers have the market power to pass through very substantial cost increases to consumers in the form of higher prices. The U.S. cigarette industry is a 4-firm oligopoly. No significant new competitors have entered the domestic market for over 40 years, and barriers to new entry remain high. There are no close substitutes for cigarettes as a product. Other tobacco products and current nicotine replacement therapies are only partial substitutes. The demand for cigarettes is inelastic. As a result, an increase in price will raise more revenue even though it causes consumption to fall.[4] Historically, U.S. cigarette manufacturers have consistently passed on the costs of higher Federal excise taxes to their customers.[5]

Cigarette manufacture in the U.S. is a profitable enterprise. In recent testimony before the Senate Agriculture Committee, I estimated that in 1996, the operating profit per pack of cigarettes was $0.30.[6] With about 24.2 billion packs of cigarettes sold that year,[7] the total operating profits of the domestic tobacco-producing subsidiaries of U.S. manufacturers came to about $7.2 billion. So long as U.S. manufacturers can pass their costs through to customers – and thus retain their 30-cent-per-pack operating margins – cigarettes will remain profitable. Even if manufacturers were saddled with tens of billions of dollars of settlement payments or Federally-imposed assessments, and even if the resulting price hikes caused

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[4] The demand for a product is considered to be inelastic when a 1-percent increase in real price results in a drop in consumption that is less than 1 percent. Although consumption falls, total sales revenue (which equals price multiplied by consumption) rises. For cigarettes, the best estimate is that consumption falls about 0.4 percent for every 1-percent increase in real price. See: Sweanor D, Ballin S, Corcoran RD, et al. Report of the Tobacco Policy Research Study Group on tobacco pricing and taxation in the United States. *Tobacco Control* 1992;1(Suppl):S31-6; Harris JE. The 1983 increase in the federal excise tax on cigarettes. In: Summers L, ed. *Tax Policy and the Economy*, vol 1. Cambridge, Massachusetts: MIT, 1987:87-111; and Harris JE. A working model for predicting the consumption and revenue impacts of large increases in the US Federal cigarette excise tax. Working Paper No 4803. Cambridge, Massachusetts: National Bureau of Economic Research, Jul 1994.): Working Paper No. 4803. One group of economists claims to have measured 0.8-percent long-run decline in consumption for every 1-percent price increase, based upon pre-1985 data on states' tax receipts. See Becker GS, Grossman M, Murphy KM, An empirical analysis of cigarette addiction. *Am Econ Rev* 1994;84(3):396-418. Such an extreme finding has thus far not been clearly replicated. Even if the demand for cigarettes were as elastic as these authors suggest, price increases would still raise revenue.

[5] Harris JE. The 1983 increase in the federal excise tax on cigarettes. *op. cit.*

[6] Harris JE. *Written Testimony Before the Senate Committee on Agriculture, Nutrition, and Forestry Hearings on the Tobacco Settlement and the Future of the Tobacco Industry*, Washington DC, September 11, 1997; Appendix Table 2.

[7] Maxwell Report for 1996. *Tobacco Reporter* April 1997.

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consumption to decline by 50 percent, domestic tobacco profits would still be $3.6 billion in 1996 dollars.

An analysis of the impact of Federal legislation on the profits of tobacco manufacturers needs to consider the profitability of their parent companies. Cigarettes are sold by highly diversify multinational firms that derive income from international tobacco divisions and non-tobacco lines of business. In 1996, I estimated that the operating profits of the international tobacco divisions of U.S. tobacco manufacturers were nearly $5.1 billion, while the operating profits of non-tobacco lines of business were nearly $7.7 billion. Even after accounting for interest payments on corporate debt and other corporate-wide expenses, the total pretax income of the parent companies was $15 billion.[8]

In recent discussions of Federal tobacco legislation, some analysts have forecast that retail cigarette prices will exceed $5.00 per pack. Interpretation of these forecasts requires that we clearly distinguish between nominal and real (or inflation-adjusted) prices. Even at a relatively low inflation rate of 3% per year, a five-dollar bill in the year 2006 would be worth less than four dollars in 1998 currency. In this report, I will frame my results in constant, inflation-adjusted dollars. This convention conforms with the provisions of recent settlements between tobacco-manufacturing defendants and several states. It is also consistent with economic models in which the demand for cigarettes depends on the real, rather than the nominal, price.

<u>Cigarette Manufacturers Have Passed Through Their Recent Settlement Costs To Consumers in the Form of Higher Prices.</u>

During 1997, defendant cigarette manufacturers entered into settlement agreements with two states – Mississippi[9] on July 3 and Florida[10] on August 25 – as well as with plaintiffs in the *Broin* flight attendant case[11] on October 9. These settlements required payments of $896.8 million in 1997, including $246.8 million to Mississippi,

[8] Harris JE. *Written Testimony Before the Senate Committee on Agriculture, Nutrition, and Forestry Hearings on the Tobacco Settlement and the Future of the Tobacco Industry. op. cit.*

[9] In the Chancery Court of Jackson County, Mississippi. In Re Mike Moore, Attorney General ex rel., State of Mississippi Tobacco Litigation, Cause No. 94-1429. Memorandum of Understanding. July 3, 1997. http://stic.neu.edu/MS/mssettle.htm.

[10] Circuit Court of the Fifteenth Judicial Circuit, In and For Palm Beach County, Florida. The State of Florida, et al., v. The American Tobacco Company, et al., Civil Action No. 95-1466 AH. Settlement Agreement, August 25, 1997. http://stic.neu.edu/Fl/flsettle.htm

[11] In the Circuit Court of the 11th Judicial Circuit In and For Dade County, Florida General Jurisdiction Division. Norma R. Broin, et al., v. Philip Morris Incorporated, et al. Case Number: 91-49738 CA (22). Settlement Agreement. October 9, 1997. http://www.tobacco.neu.edu/extra/hotdocs/broin.htm.

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$650 million to Florida, and $149 million to the Broin plaintiffs.[12] During 1998, manufacturers have thus far entered into new settlement agreements with the state of Texas[13] on January 16 and most recently with the state of Minnesota and Blue Cross/Blue Shield of Minnesota[14] on May 8. These settlements – along with continuing obligations from the previous year's settlements – will require payments totaling $2.4 billion during 1998, including $1,324 million to Texas, $588 million to Minnesota and Minnesota Blue Cross/Blue Shield, $68 million to Mississippi, $320 million to Florida, and $100 million to the Broin plaintiffs.[15]

These financial obligations can be translated into cents per pack. Thus, total 1997 settlement payments of $896.8 million amounted to 3.7 cents per pack (that is, $896.8 million divided by 24 billion packs sold). As of April of this year, cumulative payments for 1997-1998 equaled $1.712 billion, which amounted to 10.9 cents per pack.[16]

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[12] Mississippi payments in 1997 included: $170 million in an initial lump-sum payment; $15 million in costs; and $61.8 million for a pilot program to prevent underage smoking. Florida payments in 1997 included: $550 million in an initial lump-sum payment and $100 million for a pilot program to reduce underage smoking.

[13] In the United States District Court for the Eastern District of Texas, Texarkana Division, The State of Texas vs. The American Tobacco Company, et al., No. 5-96CV-91. Comprehensive Settlement Agreement and Release. January 16, 1998. http://stic.neu.edu/Tx/Texas-settlement.htm.

[14] The full text of the settlement agreement has not been made public as of this writing. The main financial terms are given at: http://www.ag.state.mn.us/press/newssearch.qry?function=detail&Layout_0_uid1=33334.

[15] Texas payments in 1998 include: $725 million in an initial lump-sum payment, $264 million for certain public health and research programs, $45 million in costs and attorneys fees, and a first-year installment of $290 million, which equals Texas' 7.25% share of state payments under the first year of the Proposed Resolution of June 20, 1997. Mississippi payments in 1998 include: $68 million, which is the state's 1.7% share of state payments during the first year of the Proposed Resolution. Florida payments in 1998 include: $100 million toward the pilot program to reduce underage smoking; and $220 million, which is the state's 5.5% share of state payments during the first year of the Proposed Resolution. Minnesota payments in 1998 include: $240 million in retroactive damages; $142 million in attorneys' fees and costs; $10 million for a special research fund; $94 million to Blue Cross/Blue Shield; and $102 million, which equals Minnesota's 2.55% share of state payments under the first year of the Proposed Resolution. (It appears that, unlike Texas, Mississippi, and Florida, Minnesota's share was based on smoking-attributable Medicaid costs rather than state population. For the differential effects of these two criteria on state recoveries, see Harris JE. *Written Testimony Before the Subcommittee on Courts and Intellectual Property, Committee of the Judiciary, U.S. House of Representatives, Oversight Hearing on "Attorneys Fees and the Proposed Global Tobacco Settlement,"* Washington, DC, December 10, 1997.)

[16] All four parent companies – Philip Morris, RJR Nabisco, Loews, and BAT Industries – charged their respective shares of 1998 initial payments to Texas to the fourth quarter of 1997. See *Philip Morris Companies Annual Report 1997*, p.55; *RJR Nabisco Annual Report 1997*, p. 67; and *Loews Corporation Annual Report* 1997, p. 79; *BAT Industries Annual Report 1997*, p. 13, and

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Figure 1 below shows the wholesale price of premium-brand cigarettes quoted by U.S. manufacturers during the period from November 1993 through April 1998.[17] In November 1993, manufacturers set their wholesale price at $1.12 per pack. This price remained unchanged until May 1995, when it increased to $1.15 per pack. Wholesale premium prices were again raised to $1.19 per pack in May 1996 and $1.24 per pack in March 1997. Thereafter, from March 1997 through April 1998, wholesale premium price increased by 14 cents per pack.

Figure 1 also shows the expected trend lines in wholesale prices based on two different assumptions. For the solid line, I assume that the March 1997 increase anticipated the nationwide settlement on June 20 and the Mississippi settlement on July 3. For the dashed line, I assume that the March 1997 price increase did not reflect such anticipated payments. Under these two assumptions, respectively, the price of premium cigarettes increased by 14 and 9 cents per pack beyond the predicted trend.

Other Components of the Retail Price of Cigarettes, Including State Excise and Sales Taxes and Wholesaler and Retailer Markups, Have Not Risen Sharply.

Table 1 below shows my analysis of trends in the individual components of the retail price of cigarettes during 1994–1997. This analysis updates an earlier study of trends during 1994–1996.[18]

As shown on Line 7, the nominal average retail price of cigarettes increased from $1.92 per pack in 1994 to $2.02 per pack in 1996, which corresponded to a rate of increase just under the overall growth in the consumer price index (CPI). By contrast, the average retail price rose to $2.12 in 1997.[19] As shown in Line 8, state and local excise taxes increased at a real rate of 1.0 percent annually during 1994–1996 and 1.3 percent annually during 1994–1997. As shown in Line 3, state sales taxes actually declined when measured as a percentage of the pre-tax price. As shown in Line 10, the Federal excise tax remained constant in nominal terms but declined in real terms.

BAT Industries Directors' Report and Accounts 1997, p. 56. As a result, total 1997–1998 settlement payments expensed during 1997 equaled $2.192 billion, or 9.1 cents per pack.

[17] Prices are quoted inclusive of the Federal excise tax, which remained unchanged at 24 cents per pack during the period covered by Figure 1.

[18] Harris JE. *Prepared Statement Before the Senate Democratic Task Force on Tobacco*, Sen. Kent Conrad (D-ND), Chairman, Washington DC, October 21, 1997

[19] The computed average retail prices in Table 1 are higher than those ordinarily reported by the Tobacco Institute, which exclude state sales taxes.

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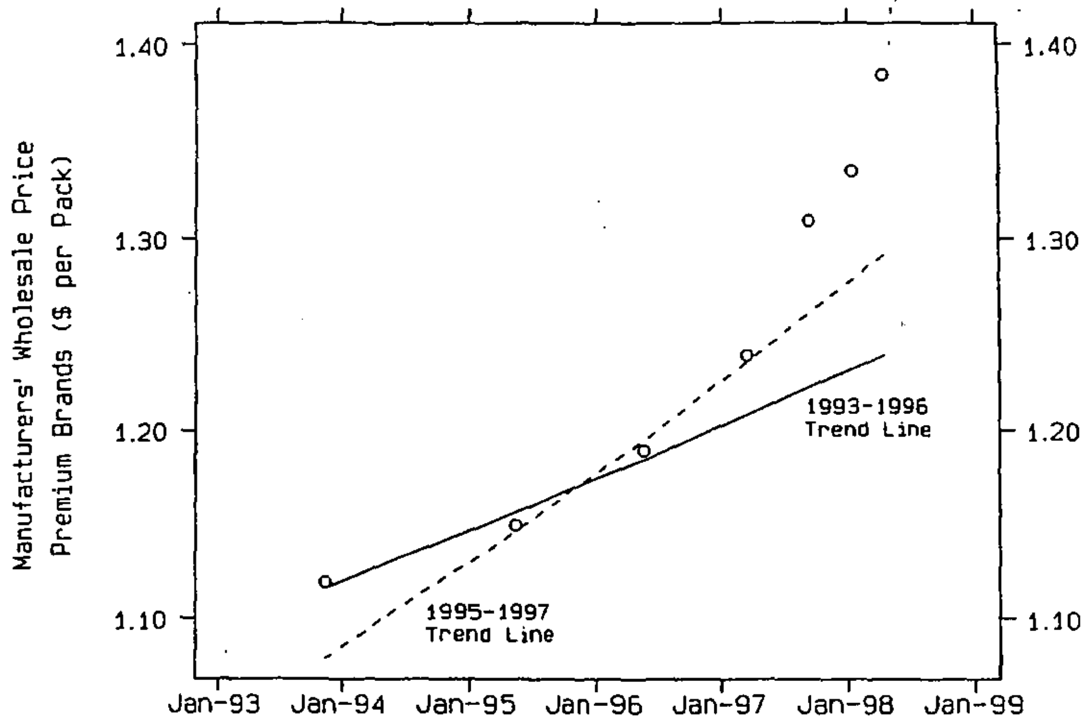
Figure 1. U.S. Cigarette Manufacturers' Wholesale Prices
on Domestically Sold Premium-Brand Cigarettes, November 1993 – April 1998



Caption to Figure 1: The open circles represent quoted wholesale prices per pack of 20 cigarettes. (Source: USDA Tobacco Situation and Outlook Report.[20]) The solid line represents the best-fitting log-linear regression line for the points from November 1993 through May 1996. The dashed line represents the corresponding best-fitting line for the points from May 1995 through March 1997. The predicted values of these two trend lines for April 1998 are, respectively, $1.24 and $1.29. The actual quoted wholesale price in April 1998 was $1.38.

[20] USDA Economic Research Service. *Tobacco Leaf Situation and Outlook Report*. Table 8: Wholesale cigarette price revisions, 1980-97. Updated 5/4/98. http://www.econ.ag.gov/Briefing/tobacco/Table8.htm

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Table 1. Retail Price, Excise and Sales Taxes, Manufacturers Revenues, and Wholesale/Retail Margins on Cigarettes, 1994-1997

	Calendar Year				Real Annual Average Change (Percent)	
	1994	1995	1996	1997	1994-1996	1994-1997
1. Expenditures on Cigarettes, Excluding Sales Taxes ($billions)	44,544	45,793	47,233	48,734		
2. State Sales Tax Revenues on Cigarettes ($billions)	2,016	2,083	2,007	2,086		
3. State Sales Taxes as Percent of Pre-Tax Price	4.53%	4.55%	4.25%	4.28%		
4. Total Expenditures on Cigarettes ($billions)	46,560	47,876	49,240	50,820		
5. State and Local Excise Taxes on Cigarettes ($billions)	7,220	7,717	7,817	7,926		
6. Total Cigarette Consumption, USDA Series (billions, cigarettes)	486	487	487	480		
7. Nominal Retail Price per Pack (cents)	191.6	196.6	202.2	211.8	-0.2%	1.0%
8. Nominal State and Local Excise Tax per Pack (cents)	29.7	31.7	32.1	33.03	1.0%	1.3%
9. Nominal State Sales Tax per Pack (cents)	8.3	8.6	8.2	8.7	-3.1%	-1.6%
10. Nominal Federal Excise Tax per Pack (cents)	24.0	24.0	24.0	24.0	-2.8%	-3.9%
11. Nominal Mfrs + Wholesale/Retail Revenues per Pack (cents)	129.6	132.4	137.9	146.0	0.2%	2.0%
12. Nominal Manufacturers Revenues per Pack (cents)	70.1	72.6	76.5	83.20	1.5%	4.7%
13. Nominal Wholesale/Retail Margin per Pack (cents)	59.5	59.8	61.4	62.83	-1.3%	-1.3%
14. Wholesale/Retail Margin as a Percent of Manufacturers' Price (%)	20.0%	19.6%	19.4%	18.8%		
15. Consumer Price Index (percent of 1982-1984)	148.2	152.4	156.9	160.5		

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Notes to Table 1:

1. Source: USDA Economic Research Service. *Tobacco Leaf Situation and Outlook Report*. Table 22 Expenditures for tobacco products and disposable personal income, 1986-97. Updated 5/4/98. http://www.econ.ag.gov/Briefing/tobacco/Table22.htm.
2. USDA Economic Research Service. op. cit. Table 23. Governmental revenues from tobacco products, 1986-96. Updated 5/4/98. http://www.econ.ag.gov/Briefing/tobacco/Table23.htm.
3. Line 2 + Line 1.
4. Line 1 + Line 2.
5. USDA Economic Research Service. op. cit. Table 23.
6. USDA Economic Research Service. op. cit. Table 1. Cigarettes: U.S. output, removals, and consumption, 1988-97. Updated 5/4/98. http://www.econ.ag.gov/Briefing/tobacco/Table23.htm.
7. 2 × Line 4 + Line 6.
8. 2 × Line 5 + Line 6.
9. 2 × Line 2 + Line 6.
10. Based on prevailing Federal tax rate of $12 per 1,000 units.
11. Line 7 – Line 8 – Line 9 – Line 10.
12. Based on the following data from company annual reports and the Maxwell Reports (*Tobacco Reporter*, March 1996, April 1997, May 1998, in press):

	1994	1995	1996	1997
3-firm (PM,RJ,Lo) shipments (billions)	386.6	383.8	390.3	393.9
3-firm (PM,RJ,Lo) revenues ($millions)	19,162.3	19,535.7	20,681.1	22,289.8
3-firm (PM,RJ,Lo) rev/pack (cents)	99.1	101.8	106.0	113.2
Less Federal Excise Tax (24 cents)	75.1	77.8	82.0	89.2
4-firm (PM,RJ,Lo,BW) revenues ($m)			23,807.3	
4-firm (PM,RJ,Lo,BW) rev/pk (cents)			100.5	
Less Federal Excise Tax (24 cents)	70.1	72.6	76.5	83.2

The first row shows total unit shipments (in billions of cigarettes) for three firms: Philip Morris, RJ Reynolds, and Lorillard. The second row shows total net sales of these three firms. (The PM and Lorillard annual report include Federal excise taxes in net sales. Since the RJ annual report excluded Federal excise taxes, RJ Reynold's share was added back to this line.) The third line shows the 3-firm revenue per pack sold, inclusive of Federal excise tax, while the fourth line excludes the Federal excise tax. The latter data reflect receipts by firms with a disproportionate share of the premium-priced market. Data for Brown & Williamson, however, were available only for 1996. (See *Brown & Williamson Tobacco Corporation Annual Review* 1996). The fifth, sixth and seventh lines therefore compute revenues per pack less Federal excise taxes for four firms in 1996. The 4-firm estimates for the remaining years were based on the assumption that ratio of 4-firm to 3-firm prices remained constant.

13. Line 11 – Line 12.
14. Line 13 + (Line 7 – Line 10 + Line 11).
15. CPI, All Urban Consumers, Annual Average.

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If one subtracts all Federal, state and local taxes from the retail price, one is left with the revenues to manufacturers, wholesalers and retailers, as shown in Line 11. During 1994–1996, this quantity rose at about the same rate as the CPI. Lines 12 and 13 decompose this quantity into manufacturers' receipts per pack and wholesale/retail margins per pack. The data clearly show that wholesale/retail margins have been declining in real terms. The only significant component of recent price increases is manufacturers' wholesale prices (Line 12.)

The results in Table 1 contradict the hypothesis that increases in manufacturers' wholesale prices resulting from settlement costs somehow cause other components of price to rise in tandem. With the exception of state excise taxes, which have been rising about a 1-percent annual real rate, the other components of price – Federal excise taxes, state sales taxes, and wholesaler/retailer markups – have not kept pace with inflation.

S. 1415 Will Result in a Real Retail Cigarette Price per Pack in 2003–2004 That is 85 Cents Higher Than the Expected Price Without Federal Intervention. By 2005–2006, the Effect of S. 1415 is 55 Cents per Pack.

Figure 2 shows the results of my analysis of the path of real cigarette prices with and without Federal intervention. Both the triangles (corresponding to S. 1415) and the open circles (corresponding to no intervention) start at $2.12 per pack in 1997. Under S. 1415, the real price rises progressively to $3.38 in 2003–2004 as the required payments under Secs. 403-404 of the Act escalate. The real price then falls to $3.07 per pack by 2006 as a result of the volume adjustment provision (Sec. 404(2)) that takes effect in 2005. Without significant Federal intervention, the real price continues to rise $2.54 in 2003, as manufacturers settle with an increasing proportion of states. Once all state settlements are in place by 2003, real price then declines slightly to $2.52 by 2006 as a result of the volume-adjustment provisions of the state settlement agreements.

My analysis of price entailed the following assumptions:

1. The Federal excise tax on cigarettes, currently at $0.24 per pack, will increase to $0.34 per pack in 2000, and to $0.39 per pack in 2002, but remain unchanged thereafter.

2. State and local excise taxes, which amounted to 33.03 cents per pack in 1997, will increase at a real, inflation-adjusted rate of 1% annually.

3. State sales taxes will remain at 4.28% of the pre-sales tax price.

4. Wholesaler and retailer markups, which amounted to 62.83 cents per pack in 1997, will keep pace with inflation.

5. The Consumer Price Index (CPI) will increase at an average annual rate of 3.0 percent.

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6. Manufacturers' wholesale prices will have two components: a base component equaling 79.50 cents per pack, which rises at the same rate as the CPI; and an additional component reflecting the costs of all settlement payments or required Federal payments.

7. In the absence of significant Federal legislation, the major tobacco manufacturers will continue to settle with individual states, as they have so far done with Mississippi, Florida, Texas, and Minnesota. Based on the trial schedules and filing dates of the individual states' complaints, I assume that 10% of the remaining suits will be settled by the end of 1998; 20% by the end of 1999; 40% by the end of 2000; 60% by the end of 2001; 80% by the end of 2002; and 100% by the end of 2003.

8. Adequate licensing procedures, export controls, and enforcement mechanisms can be established to prevent a significant illegal market in contraband cigarettes.[21]

9. Total cigarette consumption (in billions of packs annually) will follow the model: $\log Q = 3.591 - 0.006T - 0.195P$, where Q is the number of packs, P is the real price of cigarettes in 1997 dollars, T is the number of years since 1997, and *log* represents the natural logarithm.[22]

10. Smokeless tobacco manufacturers will contribute an estimated 1.2 percent of payments required under Sec. 403–405 of the Act.[23]

My analysis of the impact of S. 1415, as given in Figure 2, does not include the effect on price of any additional "look-back assessments" imposed on cigarette manufacturers for failing to meet underage smoking targets (Sec. 202(b)). If manufacturers failed to meet

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[21] Testimony of Lawrence Summers to Senate Judiciary Committee, April 30, 1998; Testimony of David Sweanor to Senate Judiciary Committee, April 30, 1998; and Testimony of David Sweanor to Senate Democratic Task Force on Tobacco Sen. Kent Conrad (D-ND), Chairman, May 4, 1998.

[22] Under this "log-linear" model, the price elasticity of demand for cigarettes rises from -0.42 at the current price of $2.12 per pack up to -0.66 at a real price of $3.38 per pack. See Harris JE. *Comments on Proposed Tobacco Industry-Wide Resolution*, Commissioned by the American Cancer Society, June 26, 1997, Table 2, note 4. Harris, JE. *Written Testimony Before the Senate Committee on Agriculture, Nutrition, and Forestry Hearings on the Tobacco Settlement and the Future of the Tobacco Industry*, Washington DC, September 11, 1997; Appendix Table 2, note 4. Harris JE, "A Working Model for Predicting the Consumption and Revenue Impacts of Large Increases in the U.S. Federal Cigarette Excise Tax," op. cit.

[23] Under Sec. 403(a)(1) of the Act, smokeless tobacco manufacturers are to contribute 3.2% of the initial $10 billion payment. Based upon Maxwell Reports (*Tobacco Reporter* April 1997, p. 22; *U.S. Trade Distribution Journal* November 21, 1997, p. 27), I estimate that 24.165 billion packs of cigarettes, 735 million 1.2-ounce cans of moist snuff, and 360 million cans of other smokeless products were sold in 1996. Under Sec.403(d)(3)(A)(1) of the Act, this would amount to 24.165 adjusted units of cigarettes, 0.29 billion adjusted units of moist snuff, and 0.09 adjusted units of other smokeless products.

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such targets, then the real price of cigarettes could rise up to an additional 15 cents per pack beyond that specified in Figure 2.[24]

My analysis of both S. 1415 and the no-intervention scenario does not include the effect on price of any additional settlement payments or judgments resulting from other litigation, such as the law suits brought by Blue Cross/Blue Shield plans. If the tobacco industry were to enter into nationwide settlement agreements with Blue Cross/Blue Shield plans similar to that of Minnesota, then my preliminary estimate is that cigarette prices would gradually rise by an additional 20 cents per pack through 2003, but fall toward zero by 2008 as manufacturers completed their scheduled payments.[25] These additional effects on cigarette prices would apply to both S. 1415 and the no-intervention case.

Under S. 1415, total U.S. cigarette consumption and manufacturers' real profits on domestic sales of cigarettes will have declined by 21.3 percent. If there were no Federal intervention, I estimate that total U.S. consumption and manufacturers' real domestic profits will decline by 12.4 percent.

Table 2 shows my estimates of the impact on price, consumption, and manufacturers' operating profits, based upon the model detailed above. Under enactment of S.1415, consumption will decline from 24 to 18 billion packs during 1997 through 2004, but will then rebound under the current volume-adjustment provision (Sec. 404(2)). By contrast, consumption under the no-intervention scenario will decline from 24 to 21 billion packs by 2006. So long as manufacturers can pass their costs on to consumers and thus retain a 30-cent-per-pack operating margin, domestic cigarette profits will follow consumption. Under S.1415, as Table 2 shows, real operating profits will fall by $1.8 billion during 1997–2003 and then rise by $0.3 billion during 2003–2006. Under a no-intervention scenario, real profits will fall by $0.9 billion during 1997–2003. In the year 2003, enactment of S.1415 would thus result in a $1 billion loss in real profit compared to a scenario in which tobacco manufacturers continued to settle cases on their own.

[24] Since the real payments under Sec. 202(b) are adjusted for changes in industry volume, they function essentially as an excise tax. (Harris JE. *Comments on Proposed Tobacco Industry-Wide Resolution*, Commissioned by the American Cancer Society). The maximum impact on price can therefore be calculated as the maximum real payment ($3.5 billion) divided by base consumption (24 billion packs).

[25] The Minnesota settlement provides for payment of $469 million to Blue Cross/Blue Shield over a five year period. Since Minnesota's population is approximately 1.75% of the total U.S. population, a comparable payment to all remaining BC/BS plans would equal $5.3 billion. If manufacturers gradually entered into comparable 5-year settlement agreements with the remaining BC/BS plans during 1998–2003, then annual payments would peak at $4.7 billion in 2003 and then fall to zero by 2008.

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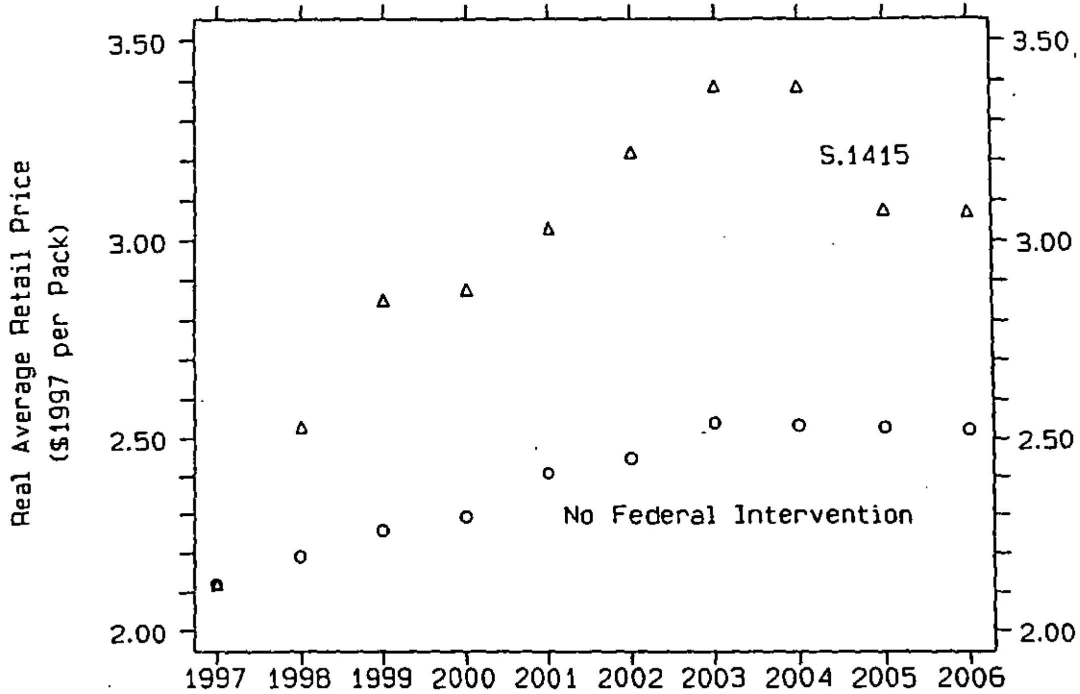
Figure 2. Real Average Retail Price of Cigarettes, 1997–2006, With Enactment of S.1415 Compared to No Federal Intervention



Caption to Figure 2: The triangles represent the real average retail price resulting from enactment of S. 1415 (RS). The open circles represent the real average retail price if no significant Federal legislation is enacted. The real price under S. 1415 falls in 2005 because the volume adjustment provision (Sec. 404(2)) takes effect. See text for assumptions.

Table 2. Comparative Impact on Cigarette Retail Prices, Total Consumption, and Operating Profits of Domestic Tobacco Divisions of U.S. Cigarette Manufacturers, 1997-2006

	No Federal Intervention				Enactment of S.1415(RS)			
Year	Nominal Retail Price ($/pack)	Real Retail Price ($/pack)	Total Cons. (billions)	Real Operating Profits ($billions)	Nominal Retail Price ($/pack)	Real Retail Price ($/pack)	Total Cons. (billions)	Real Operating Profits ($billions)
1997	2.12	2.12	24.0	7.2	2.12	2.12	24.0	7.2
1998	2.26	2.19	23.5	7.1	2.61	2.53	22.0	6.6
1999	2.39	2.26	23.1	6.9	3.02	2.85	20.6	6.2
2000	2.51	2.29	22.8	6.8	3.14	2.88	20.3	6.1
2001	2.71	2.41	22.1	6.6	3.41	3.03	19.6	5.9
2002	2.84	2.45	21.8	6.6	3.73	3.22	18.8	5.6
2003	3.03	2.54	21.3	6.4	4.04	3.38	18.1	5.4
2004	3.11	2.53	21.2	6.4	4.16	3.39	18.0	5.4
2005	3.20	2.53	21.1	6.3	3.90	3.08	19.0	5.7
2006	3.29	2.52	21.0	6.3	4.01	3.07	18.9	5.7

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Discussion and Conclusions

My analysis of the provisions of S. 1415 indicates the peak effect of the proposed legislation will occur during 2003–2004. Starting in 2005, the volume-adjustment provision (Sec. 404(2)) will substantially reduce required payments by participating manufacturers.[26]

At its peak impact in 2003–2004, S. 1415 will raise the real price of a pack of cigarettes by 85 cents in comparison to the case where there is no significant intervention. At its peak impact in 2003–2004, S. 1415 will cause total cigarette consumption to decline by an additional 3.2 billion packs in comparison to the base case. The Act will also cause manufacturers' real annual pre-tax operating profits to decline by $1 billion in comparison to the no-intervention scenario.

By 2006, S. 1415 will raise the real price of cigarettes by 55 cents in comparison to the no-intervention case. At that time, the Act will result in a decline in annual cigarette consumption by 2.1 billion packs more than the base case. It will also cause manufacturers' real pre-tax operating profits to decline by $0.6 billion per year in comparison to the no-intervention scenario.

My analysis does not predict financial insolvency for the U.S. domestic tobacco industry. The industry as a whole – as well as individual firms – will lose money but remain profitable.

My analysis entailed three key assumptions. First, I assumed that manufacturers can and will pass through the costs of legal settlements and legislative assessments to consumers in the form of higher prices. My analysis of the impact of the industry's legal settlements on cigarette prices during 1997–1998 amply supports this assumption. Cigarette manufacturers have already raised the price of their product to pay for their legal costs. Second, I assumed that the payments required under S. 1415 would not have a multiplier effect on other components of cigarette retail prices, including state excise and sales taxes, Federal excise taxes, and wholesaler/retailer markups. My analysis of trends in the components of cigarette retail prices during 1994–1997 amply supports this assumption. In particular, when cigarette manufacturers raised their prices by approximately 7 cents per pack during 1997, the other components of cigarette price simply continued to follow past trends.

Third, I assumed that in the absence of significant Federal intervention, defendant cigarette manufacturers would continue to settle law suits filed by individual states according the basic model set forth in the agreements with Mississippi, Florida, and Texas. Under such a model, total payments to all states would rise to $8 billion by

[26] In 1997 constant dollars, manufacturers payments will fall $20.7 billion in 2004 to $16.4 billion in 2005, when the volume-adjustment provision takes effect.

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2003, with each state receiving a negotiated share of the total. Although the details of the Minnesota settlement are not available at this writing, it appears that this state has likewise followed the industry's model. Accordingly, in my base no-intervention scenario, the defendant manufacturers would gradually settle state cases until all were concluded by 2003. Previous analyses of the impact of Federal tobacco legislation have not generally been explicit about their base-case assumptions. Many analysis appear to have assumed implicitly that the industry would enter no more settlements and prevail in court. The experience of the first four state suits does not support this assumption.

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inevitable. This is clearly demonstrated by the detailed economic analyses of Jeffrey E. Harris, M.D. Ph.D. and David Sweanor.

Not only would a bankruptcy filing not be necessary, but it would provide the filing company with only an incomplete answer to continuing liability. The Bankruptcy Code is well designed to protect the interests of existing claimants while allowing companies an opportunity to reorganize their affairs. The Bankruptcy Code does not and cannot discharge, limit or address the liability of a filing company for post-bankruptcy actions. So long as the tobacco companies continue to manufacture, market and sell their products, new liabilities for damaging the health of individuals who use those products will continue to accrue.

Lastly, there would be very real disincentives for a tobacco company to file a bankruptcy. A bankruptcy filing would place a tobacco company and all of its assets and affairs under the jurisdiction of a federal court with broad equitable powers. This court would have the power to enforce the rights of creditors and other interested parties to investigate, review and be heard on issues touching virtually every aspect of the company's business. A tobacco company bankruptcy might give its creditors an effective forum in which to convincingly argue for the termination of the company's business and the complete liquidation of its assets. A tobacco company bankruptcy, because it would automatically stay actions against the company outside of the bankruptcy court, would also serve to focus the attention and energies of civil litigants on corporate parents and other affiliates of the tobacco company, a trend in recent court actions.

OVERVIEW OF FEDERAL BANKRUPTCY LAW

A voluntary federal bankruptcy is relatively easy to initiate. In the case of a company such as a tobacco manufacturer, the corporation, after obtaining the necessary authorizations from its board of directors, would file a simple form petition with the bankruptcy court, together with other minimal financial information and a filing fee. The corporation would file lists of assets and liabilities, a statement of financial affairs, and a list of all creditors. The bankruptcy case is opened immediately. Initially, creditors can not oppose a voluntary petition and no court order is necessary. Creditors can later ask that the bankruptcy court dismiss the bankruptcy for a number of reasons. These reasons can include a bad faith initial filing by the company, called the "debtor" once the bankruptcy is filed, and the failure by the company to comply with the disclosure requirements and operating restrictions inherent in the bankruptcy process. Such dismissals are relatively rare. A company does not need to demonstrate that it is insolvent in order to begin a bankruptcy.

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An involuntary bankruptcy petition can be filed against a corporation by three or more of its creditors. Unlike the case in a voluntary petition, the petitioning creditors must prove that the subject company is either generally not paying its debts as they come due, or that a receiver was appointed for the company or its assets shortly before the filing of the petition.

A corporation such as a tobacco company might file one of two distinct types of bankruptcy: a liquidation under "chapter 7" or a "chapter 11" reorganization.

Chapter 7. After a corporation files a petition for relief under chapter 7 of the Bankruptcy Code, a notice of the bankruptcy filing is sent by the bankruptcy court to all creditors. The notice would also identify the interim trustee, usually an attorney, appointed from approved lists.

Representatives of the corporation would attend a meeting of creditors in the first 20 to 40 days after the filing in order to answer questions which either the interim trustee or the creditors might have regarding the corporation, its assets and liabilities. At the meeting, the creditors also have the option of electing an individual other than the named interim trustee to serve as trustee, although this is rarely done. The creditors may form a committee to investigate the corporation or to assist in the liquidation of assets, although this is more common only in larger chapter 7 cases and in chapter 11 reorganizations.

The chapter 7 trustee is charged with responsibility for liquidating the corporation's assets. The liquidation proceeds are distributed to creditors according to statutory priorities: secured creditors receive the proceeds of their collateral; tax claims and other administrative liabilities including the expenses of the trustee and any creditors' committees are then paid out of any available funds; unsecured creditors are paid after administrative claims; and, lastly, any remaining funds are paid to stockholders.

A chapter 7 liquidation would require a significant amount of time from the corporation's officers and directors during the first several months because of the necessary court filings. It is also likely that the trustee and any creditors' committees would require a significant amount of guidance in performing their functions.

In the course of a corporate chapter 7, all of the company's assets would be liquidated for the benefit of creditors and the company would go out of existence. There would be no legal discharge of the company's liabilities but existing claimants who had received only part of the amounts owed and true future claimants would find that there no longer existed an entity against which their claims could be pressed or assets from which the claims could be paid.

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Chapter 11. Corporations can reorganize their affairs in chapter 11 under bankruptcy court protection. Chapter 11 can also be used by a company to liquidate its assets while retaining more control of its affairs than would be possible in chapter 7. A chapter 11 liquidation is often used in an attempt to obtain greater than distress values for assets. The initial court filings are similar to those in chapter 7. A notice of bankruptcy is sent to all creditors and a meeting is called.

A trustee is not named to manage the company's affairs unless a party in interest convinces the court that the company is either unwilling or incapable of managing its own business. Even though the court does not play a direct role in the day to day operations of a debtor as a matter of course, the court does have jurisdiction to remove the management of the debtor and appoint an examiner or trustee if the court finds that the company is not being honestly or competently managed. All parties in interest, including all creditors, have very broad rights to inquire into the assets, liabilities, affairs and operations of a company in bankruptcy. These inquiries are similar in form and scope to civil discovery in the federal courts.

As an alternative to the possible appointment of a chapter 11 trustee who would assume operational control of the corporate debtor, the bankruptcy court could appoint an examiner to investigate allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or other irregularities in the business of the debtor. The court would have to find that the appointment of an examiner is in the interests of creditors. Alternatively, the court would be required to appoint an examiner on the request of a creditor or other interested party if the corporate debtor's liquidated unsecured debts, other than trade debts, taxes and debts owing to insiders exceed $5,000,000. Thus, it is likely that a tobacco company bankruptcy would result in the organization of one or more creditors' committees and the appointment of an examiner.

Court approval must be sought and obtained for all out of the ordinary transactions including significant asset sales.

A company in chapter 11 has the exclusive right during the first 120 days of its bankruptcy to file a disclosure statement and plan of reorganization. The disclosure statement must provide creditors with information about the debtor's business, its financial difficulties and its prospects for a reorganization. Where the company has no intent of reorganizing, the disclosure statement describes a liquidating plan under which the company retains control of its affairs, pays creditors from asset sales or cash flow and ultimately ceases operations entirely.

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If a debtor does not file its plan within the first 120 days of its bankruptcy or obtain confirmation of that plan within the first 180 days or a court-approved extension, any other party in interest, usually creditors, may then file a plan. Although many courts impose case-specific deadlines for a debtor to obtain court approval of a plan of reorganization or face dismissal or conversion of the case to chapter 7, there is no statutory deadline to file a plan or obtain court approval.

Plans of reorganization, including liquidating plans, must generally be approved by the creditors and confirmed by the bankruptcy court. It is sometimes possible to obtain court confirmation of a plan with the approval of some, but not all, creditors if it can be demonstrated that the creditors are to receive at least as much as they would in a chapter 7 liquidation.

Clearly, the most significant liabilities from the perspective of the tobacco companies are those caused by the use of their products. Unless a corporation liquidates its assets in chapter 11 and ceases operations, confirmation of a plan of reorganization discharges the corporate debtor from pre-bankruptcy claims and liabilities except to the extent that provisions are made for the treatment of those claims and liabilities in the chapter 11 plan. However, a bankruptcy discharge will not limit or hinder the rights of claimants whose causes of action are based on the companies' post-bankruptcy conduct. So long as the tobacco companies continue to manufacture, market and sell their products, bankruptcy cannot be a complete answer to their biggest liability problem.

There have been very significant developments in the law over the course of the past sixteen years in the bankruptcies of companies which needed to provide for the payment of mass tort claims based on pre-bankruptcy conduct but which claims had not become fixed at the time of the bankruptcy filing. A product may be claimed to cause an injury which does not manifest itself until many years after use of or exposure to the product. Traditionally, it had been very difficult to write chapter 11 plans which would address liabilities based on pre-bankruptcy conduct, legally recognizable "claims" in the bankruptcy, but which would not become known to the claimant or the manufacturer until long after the bankruptcy filing. The relative "success" of chapter 11 plans as those advanced on behalf of the manufacturers of intrauterine devices, asbestos and silicone gel breast implants is based on the creation through the bankruptcies of claims adjudication procedures and trust funds which would determine the amounts of the claims which had not become fixed as of the bankruptcy filing date and would provide a payment mechanism.

These developments would not make bankruptcy more attractive to the tobacco companies, however. The intrauterine devices, asbestos and silicone gel breast implant manufacturers shared a fundamental common characteristic, presumably not

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shared by the tobacco companies: those manufacturers did not seek to emerge from bankruptcy reorganization continuing to sell their liability-generating products. The "future claims" addressed in the chapter 11 plans of those manufacturers actually addressed liabilities arising from their pre-bankruptcy conduct, but which were not evident or quantified by the time of the bankruptcy filing. A tobacco company in bankruptcy could not prospectively discharge or limit its liability arising out of the post-bankruptcy manufacture, marketing and use of its product.

STRATEGIC BANKRUPTCY FILINGS

Why might a company put itself into bankruptcy? A bankruptcy filed for strategic reasons may be said to be based on the need to fundamentally reorganize a company's business or finances in ways which would not be available under the usual laws of contract and civil liability. A company need not be insolvent on either a balance sheet or cash flow basis to file a voluntary petition for relief under the Bankruptcy Code. A filing simply must be made in good faith with a demonstrable need for the relief available under the federal statute. Corporate bankruptcies have been filed where companies have sought to terminate all or most of their current operations, liquidate their assets and make equitable distributions to creditors; where companies have amassed established liabilities in excess of their abilities to pay without extraordinary business disruptions; where companies have wanted to sell all of their assets or operating divisions to third-parties without conveying also the liabilities associated with those assets; and where companies have sought to terminate leases and other executory contracts which could not be terminated outside of bankruptcy without significant penalties. These may be considered the strategic business uses of bankruptcy.

While it is not possible to say that no single member of a particular industry will not opt to file a bankruptcy over a number of years for one or more of these strategic reasons, it is nonetheless evident from the Harris and Sweanor analyses that neither the Bill nor the other proposed legislation would require, much less substantially contribute to, a strategic bankruptcy filing by a tobacco company.

TACTICAL USES OF BANKRUPTCY

Not infrequently, a company may file a bankruptcy for entirely tactical reasons with much narrower goals than the strategic concepts described above. This is usually done to obtain the benefit of the automatic stays of proceedings which immediately stop most pre-bankruptcy civil actions attempting to enforce or collect claims and liabilities. An example of this would be a company which needed to prevent a creditor from attaching its assets, or to prevent a lender from demanding immediate repayment of a defaulted or matured credit facility. Larger companies tend

CLINTON LIBRARY PHOTOCOPY

to find more practical and effective alternatives than bankruptcy to achieve such narrowly defined goals.

The automatic stays of proceedings which arise immediately upon the filing of a voluntary petition for relief do not stay actions against corporate parents and other affiliates. Any effort by a corporate debtor to extend the benefit of the stays of proceedings to such affiliates would provide the bankruptcy court with, at least, the beginning of a reason to inquire into the assets and affairs of the non-bankrupt affiliate. In such circumstances, creditors commonly argue that if a non-bankrupt entity is to receive the benefit of the bankruptcy stays of proceedings, it should then also be subject to the investigative powers of creditors committees and examiners and, perhaps, subject to some of the operating limitations of a company in bankruptcy.

For the reasons set forth in the economic analyses of the Bill, even a tactical bankruptcy filing would be unlikely by a tobacco company because of the legislation's provisions that the annual assessments be funded through product price increases.

THE TOBACCO COMPANIES' BANKRUPTCY THREAT

In the course of negotiations, a company can use many arguments to explain why it should be permitted to achieve its goals, and why it should not be required to undertake or recognize certain obligations which it may view as burdensome. The bankruptcy threat as a negotiating tactic is unusual because it is vague. As a tobacco company threat, a possible bankruptcy can be brought out at any stage in the negotiations or national debate and in response to any regulatory or economic provision. Because of the extraordinarily broad right to file for bankruptcy protection, it is impossible to prove that any given company will not, over a course of years, resort to the bankruptcy courts. Recognizing this fact, however, also illustrates the shallowness of the threat. Because a bankruptcy filing would not be made necessary or inevitable by the legislation under discussion, because of the limited relief available in bankruptcy with respect to liability for continuing product lines, and because of the significant negative implications for management of a tobacco company while in bankruptcy, bankruptcy can be accurately regarded as an illogical and poorly designed business response to the proposed legislation.

A logical case cannot be made that a bankruptcy filing would be in the interest of one or more of the tobacco companies. The prospect of a tobacco company bankruptcy, therefore, is useful to the companies only as a threat and not a genuine option.

CLINTON LIBRARY PHOTOCOPY

Tob- set - bankruptcy

Comprehensive Tobacco Legislation will Not Cause Bankruptcy

Claims by the tobacco companies that the McCain bill will drive them into bankruptcy are just not convincing for two key reasons. First, the legislation is designed to facilitate the pass-through of manufacturer payments to the prices of tobacco products, minimizing the impacts on the profits of the manufacturers themselves. Second, the industry has a significant cash flow and net assets to absorb the reduced volume as prices rise.

But won't the large payments in the McCain legislation drive tobacco companies into bankruptcy?

The opinion of the objective experts at the Federal Trade Commission is that even large price increases will have little impact on profits. They find that the AG settlement, which raised prices by 62 cents, lowered the profitability of the tobacco industry by only about 15 percent. By their method, *the $1.10 price increase in the McCain bill would lower profitability by less than 25 percent.*

A 25 percent drop in domestic tobacco products can readily be absorbed by an industry which is well diversified into other product lines. Even the most vulnerable participant in this industry, RJR Nabisco, has almost $11 billion in Nabisco stock, which much more than outweighs its debt obligations. The only real risk of bankruptcy comes from losing a rash of lawsuits in court.

Is the risk of bankruptcy higher for RJR Nabisco than for the other companies?

While this is a difficult question to answer with certainty, it appears that way. This is for three reasons. First, the company went through a leveraged buyout in the late 1980s which left it with a high debt load. Second, while they are a diversified company, they are less well diversified than their competitors such as Phillip Morris or Loews. Third, they have a declining domestic market share.

That said, it is important to look at the facts before panicking about bankruptcy risk. RJR Nabisco had operating profits in its domestic tobacco business of about $1.5 billion in 1997, and another $700 million in net operating profits of its international tobacco business (a business that has been growing at 8 percent per year). Moreover, it has over $4 billion in net assets from its Nabisco stock holdings net of its debt obligations. This is not a company teetering on the edge of bankruptcy.

Will company-specific youth lookback surcharges drive the tobacco companies into bankruptcy?

Company-specific youth lookback surcharges are an important feature of any comprehensive plan to combat youth smoking. They will help ensure that individual manufacturers undertake meaningful efforts to reduce youth use of their products. The very reason that they are so effective is because, unlike other payments made by the industry (including industry-wide lookback surcharges), they are difficult to pass on to prices. For that reason, they provide a real bottom-line incentive for companies.

This is an industry which can clearly bear reasonable company-specific penalties and remain viable. The operating earnings of RJR Nabisco, Phillip Morris, and Loews for 1997 were $18 billion dollars. This allows plenty of room for serious financial incentives for individual companies that do not meet youth reduction targets without posing any significant bankruptcy risk.

Bankruptcy Risk -- Talking Points

The Payments are Made by Tobacco Consumers, Not Tobacco Manufacturers: The primary goal of comprehensive tobacco legislation is to reduce youth tobacco use. The single most effective means of accomplishing this goal is to raise the price of tobacco products. As a result, the McCain legislation and other bills facilitate the pass-through of industry payments to the price of tobacco products. Mechanisms such as the allocation of industry payments by market share, and volume adjustments which reduce industry payments as volumes fall, will ensure that these payments are made by consumers, not manufacturers.

Payments Made by Tobacco Consumers Have Modest Impact on Manufacturer Profitability: The opinion of the objective experts at the Federal Trade Commission is that even large price increases will have little impact on profits. They find that the AG settlement, which raised prices by 62 cents, lowered the profitability of the tobacco industry by only about 15%. By their method, *the $1.10 price increase in the McCain bill would lower profitability by less than 25%.*

The Tobacco Industry Has Substantial Financial Resources: The U.S. tobacco industry is large, well-diversified, and financially strong; the operating earnings for 1997 for Phillip Morris, RJR Nabisco, and Loews was $18 billion. The industry leader, Phillip Morris, is particularly well positioned to absorb decreases in their domestic tobacco earnings:

- Their stock is currently valued at almost $100 billion.
- They had $4.7 billion in domestic tobacco operating profits in 1997
- They also had operating profits of $4.6 billion on their international tobacco business.
- They are also a well diversified company that has operating profits of almost $5 billion from other lines of business such as food and beer.

Even the most vulnerable in this industry, RJR Nabisco, has substantial financial resources:

- For 1997, RJR Nabisco's domestic tobacco business had operating profits of $1.5 billion
- The company also has a rapidly growing international business which had $670 million in operating profits in 1997.
- In addition to their tobacco businesses, RJR Nabisco has a substantial asset: its holdings of 80 percent of Nabisco, valued at almost $11 billion dollars. This exceeds by more than $4 billion the entire value of RJR Nabisco's parent company debt obligations.

The Decline in Profits from Large Price Increases will Not Cause Bankruptcy: Reductions in domestic profits on the order of 25 percent or more can be readily absorbed. This will still leave a profitable domestic tobacco business, in addition to the strong income derived from their food, beer, insurance, and other lines of business.

Tob - scr - bankruptcy

cc: EK
+ File: Tobacco-Bankruptcy

MEMORANDUM

DATE: April 13, 1998

RE: Effect of Chapter 11 Bankruptcy

Concern has been raised that RJR might file Chapter 11 bankruptcy. This concern is based on the possibility of a large verdict against RJR including punitive damages in the pending Minnesota lawsuit and the fact that recently Phillip Morris paid RJR's share of the Mississippi settlement because RJR did not have the cash to pay its own share. If RJR were to file bankruptcy, it would put the other tobacco companies at a disadvantage because of the Automatic Stay under 11 U.S.C. §362.

11 U.S.C. §362 provides that upon the filing of bankruptcy all actions to litigate or collect money from RJR would cease. In general, all debt that existed prior to the filing of the bankruptcy would not need to be paid until after a plan of reorganization is approved by the court. This debt includes:

* existing accounts payable
* existing taxes
* existing payroll
* existing judgments and
* unsecured bank and other long term debt.

The process of getting a plan of reorganization approved by the court could take years as evidenced by the three year old Dow Corning bankruptcy which still does not have a plan of reorganization. During this time, no litigation against RJR could

be commenced or prosecuted except under the auspices of the bankruptcy court. Under the plan of reorganization, there are means by which certain debts existing prior to the bankruptcy are either not repaid or repaid only in part.

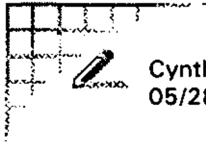
Debts that are incurred after the filing of the bankruptcy are payable during the bankruptcy. In addition, there are certain costs associated with the bankruptcy including attorneys' fees which must be paid.

Certain contracts, including union labor contracts and retirement agreements with retirees can be modified during the bankruptcy. These contracts do not need to adhered to during the pendency of the bankruptcy (subject to certain requirements of the bankruptcy code §§1113 and 1114).

Secured debt must be paid to the extent that there is collateral securing it. Otherwise, the creditor is entitled to the return of his collateral.

Thus, if RJR chose Chapter 11 bankruptcy, RJR would have an opportunity to operate at a marked competitive advantage over Phillip Morris for up to three to four years.

Tob - rec - bankruptcy



Cynthia Dailard
05/28/98 11:02:08 AM

Record Type: Record

To: Laura Emmett/WHO/EOP

cc:
Subject: additional technical correction to the McCain bill.

COMM_BAN.W This morning, I handed Elena a 20-page document including technical corrections to the McCain bill for her review. Here is an additional correction from DOJ on bankruptcy that should be added to that document. I don't know whether this is actually a technical correction, or whether it is more substantive/policy in nature, but I will leave that up to Elena to decide. Let me know whether you want to give Elena this additional comment or whether you prefer for me to incorporate this comment in the overall document and just give her a new version.

Bankruptcy Language for Title II and IV or for Title XI:

Any obligation, interest, or debt of a tobacco product manufacturer arising under [this Title] [under this Act] shall be given priority and shall not be rejected, avoided discharged, or otherwise modified or diminished in a proceeding, under Title 11, United States Code, or any liquidation, reorganization, receivership, or other insolvency proceeding under State law. A trustee or receiver in any proceeding under Title 11, United States Code, or any liquidation, reorganization, receivership, or other insolvency proceeding under State law, may avoid any transfer of an interest of the tobacco product manufacturer, or any obligation incurred by such manufacturer, that was made or incurred on or within 2 years before the date of the filing of a bankruptcy petition, if such manufacturer made such transfer or incurred such obligation to hinder or defeat in any fashion the payment of any obligation, interest, or debt of the manufacturer arising [under this Title] [under this Act}. Any property vesting in the manufacturer following such a proceeding shall be subject to all claims and interest of creditors arising [under this Title] [under this Act].

Tob-scr-bankruptcy

RJR and Bankruptcy Risk

Summary

We undertake a detailed assessment of the bankruptcy risk for RJR under the type of tobacco legislation that is currently contemplated by the Congress. Our key findings are:

- Even the substantial price increases envisioned by the President's budget or other recent legislation will not by themselves pose a risk of bankruptcy for RJR.
- There remains some risk, however, due to company-specific legal and other liabilities.
- But this risk is largely present even in the absence of legislation. What is key is the *incremental impact* of legislation on this risk.
- This incremental impact is the product of two factors: the effect of legislated price increases on the ability of RJR to absorb risk; and the impact of the legislation on the level of risk.
- This incremental impact is reduced through a number of bankruptcy-preventing features of the legislation which facilitate the pass-through of payments to tobacco prices.

Background on RJR

- RJR is comprised of three business lines: domestic tobacco; international tobacco; and Nabisco.

- Their domestic tobacco market share (24%) is second to Phillip Morris (49%). Moreover, it has been declining secularly in recent years; from 1992 to 1997, unit sales declined by slightly under 5% per year, as opposed to 1.6% for the industry as a whole.

- Their international market share, at 4%, is only about one-third of that of Phillip Morris. On the other hand, their international business has been growing at a rapid 8% per year pace.

- The company holds 80% of Nabisco, which is publicly traded. These 213 million shares are worth $10.2 billion in the public market and likely higher in the merger market.

- RJR, relative to the rest of the domestic tobacco industry, has greater financial leverage, left over from the LBO of the late 1980s. Between debt and preferred stock, RJR has $6.5 billion in obligations.

No Bankruptcy Risk from Price Increases Alone (Ignoring Liability Costs)

Cash Flow Model

- Under this approach, bankruptcy risk is assessed by comparing the operating cash flow to the firm each year with its fixed obligations.

- Results in **Table**. There are three key underlying assumptions:

  - Effect on volumes: here we follow the Treasury analysis that underlied DS Summers' testimony. A number of Wall Street analysts have criticized this analysis as understating the reduction in volumes.

  - Effect on margins: here we assume a substantial fall in margins as volumes decline, from the current level of 31% to as low as 20% with a $1.50 price increase. This is a conservative estimate based on conversation with Wall Street analysts.

  - Feedback into international business: here we assume no feedback; some on Wall Street have suggested that international sales might suffer as a result of features of tobacco legislation.

- Main conclusion from that Table: substantial increases in the price of tobacco products will lower this cash flow, reducing the "cushion" against bankruptcy. But even price increases of $1.50, or more, will not come close to driving cash flow negative.

Enterprise Value

- Under this approach, bankruptcy risk is assessed by comparing the present value of the various business units of RJR with its debt and other obligations.

- This analysis yields a more positive picture than the cash flow analysis because of a very large asset that yields little cash flow: RJR's holdings of Nabisco.

- Netting this $10.2 billion asset against RJR's $7 billion in debt & preferred stock, there is a positive balance of $3 billion.

- Additionally, the international tobacco business, which currently earns $800 million and is growing rapidly, is conservatively worth $4-5 billion dollars.

- Thus, unless the value of the domestic tobacco business becomes large and negative, there is little risk of bankruptcy from this perspective.

- This conclusion is not so different from the cash flow conclusion if one recognizes that RJR could always increase cash flow by selling its Nabisco shares and paying off its debt.

While there would certainly be some tax disadvantage to this transaction, there would be an offsetting merger premium to the stock value from selling Nabisco.

Table: Cash Flow Analysis

Item	1998 Estimate	2003 Estimate, No Legislation	2003 Value, $1.10/Pack	2003 Value, $1.50/Pack
Domestic Sales	4.9	4.9	3.6	3.3
Operating Costs	3.4	3.4	2.8	2.6
U.S. Operating Contribution	1.5	1.5	0.8	0.7
Int'l Operating Contribution	0.8	1.2	1.2	1.2
Depreciation Allowance	0.3	0.3	0.3	0.3
Nabisco Dividend	0.2	0.2	0.2	0.2
Corp & Other Expenses	0.2	0.2	0.2	0.2
EBITDA	2.6	3.0	2.3	2.2
Capital Expenses	0.3	0.3	0.3	0.3
Interest Expense	0.6	0.5	0.6	0.6
Net Cash Flow	1.7	2.2	1.4	1.3
MEMO: Common Dividends	0.7			
EBITDA/ Interest	4.3	6	3.8	3.7

Liability and Other Company-Specific Charges

There are two key questions for evaluating the impact of tobacco legislation: the extent to which it lowers RJR's ability to absorb a given amount of company-specific risk; and the extent to which it increases or decreases that amount of risk.

The Impact of Legislation on the Cushion, Given Risk

- Tobacco legislation *only poses an incremental bankruptcy risk for company-specific costs that fall in the range of the reduced cushion.* This is illustrated in the attached **Figure**.
  - Annual company-specific costs above $2.2 billion would threaten solvency absent any legislation.
  - Annual company-specific costs under $1.4 billion should not significantly threaten solvency.
  - It is only company-specific costs in the range of $1.4-$2.2 billion which incrementally induce bankruptcy because of this legislation.

The Impact of the Legislation on the Amount of Risk

Tobacco legislation can impact the amount of company-specific risk faced by RJR in three ways:

- It can raise or lower liability risk. The original AG settlement clearly lowered liability risk, by removing punitive damages and class action suits, and by capping industry liability. The McCain bill only includes a cap. Some have gone so far as to claim that this actually increases liability risk, by setting up the "flypaper" of a $6.5 billion dollar fund for liability costs.
- It can raise or lower annual legal costs. Most analysis of legislation has assumed that legal costs will fall. But recent Wall Street opinion of the McCain bill is that it might increase significantly legal costs, once again through attracting suits.
- It can impose company-specific youth lookback penalties.

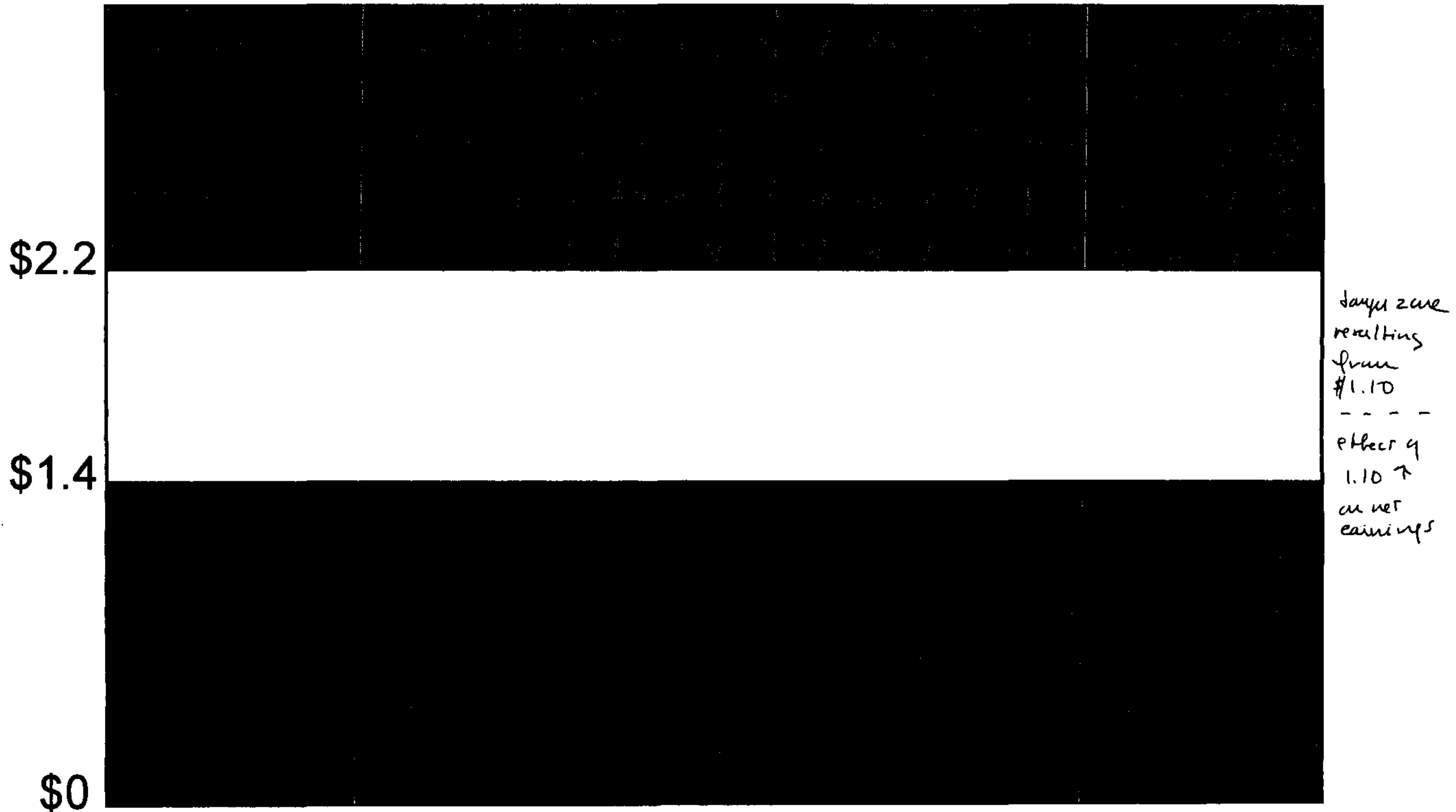
Bankruptcy-Protecting Features of Legislation

It is important to keep in mind that it is only the company-specific piece of all of these risks that are relevant. Industry-wide settlements or payments that are apportioned by current market share can be passed on to price and do not themselves impose bankruptcy risk, although they do further lower the "cushion".

There are a number of features of both the AG settlement and other legislation in this area which

ANNUAL AMOUNT OF COMPANY SPECIFIC LIABILITY

BILLIONS OF DOLLARS



will operate to insulate RJR (and other tobacco companies) from bankruptcy risk by facilitating pass-through to prices:

- Allocation of payments by market share, so that if a given company's volumes decline by a relatively larger amount, they bear a smaller share of the industry payments

- Volume adjustments, which hold the effect of the legislation on the price per pack of cigarettes constant even as volumes fall.

- Pass-through provisions, which actually mandate that all participants pass these payments onto prices.

- Limited anti-trust exemptions, which facilitate industry collusion in establishing the pass-through to prices.

- Allocation of the bulk of liability costs by market share in some bills, which allows the industry to pass liability costs on to price.

Given these features, the large payments being made by the industry will operate simply to increase the price per pack of cigarettes, greatly mitigating any solvency risk for RJR and the other companies.

- Indeed, given the anti-trust exemption, an assumption of 100% passthrough may be conservative; it is certainly possible (as noted by the FTC analysis) that producers pass-through more than 100% of the costs of this legislation onto prices, actually increasing their margins in the process. In this case, our analysis overstates any bankruptcy risk to RJR.

The Implications of Bankruptcy

- In assessing these risks, it is important to keep in mind the distinction between financial and operating bankruptcy. Even if RJR can't meet its debt obligations, it can still operate as a viable commercial entity.

- Moreover, even if there is operating insolvency, this does not imply that there will be a dramatic reduction in the total of industry payments under this settlement. A number of RJR's brands would be taken over by other industry participants. Lastly, most of the smokers who leave RJR brands would begin smoking other brands.