NLWJC - Kagan

DPC - Box 045 - Folder 010

Tobacco-Settlement: Industry Performance

Tob - ar - industry analyses

Bruce N. Reed
01/26/99 02:32:46 PM

Record Type: Record

To: Elena Kagan/OPD/EOP, Cynthia A. Rice/OPD/EOP

cc:
Subject: Outperform

Gary Black has it all figured out. All we have to do is give the industry an offset for liability judgments, and we can settle. Gee, I wonder where he got that idea.

As Litigation Ills Mount, Industry Split On Whether To Embrace Settlement With Feds..

Gary Black (212) 756-4197
Jon Rooney (212) 756-4504
January 22, 1999

HIGHLIGHTS

1. We sense a split in the industry over whether to embrace the concept of a new settlement with the federal government as a vehicle by which to bring closure to this litigation wave. Over the next few weeks, we expect industry CEOs and their lawyers to open discussions with plaintiff counsel Richard Scruggs and DOJ lawyers, to assess the pros and cons of a new federal settlement.

2. Given explicit language in the 1962 Medical Cost Recovery Act (MCRA) that the federal government has the statutory authority to "institute legal proceedings against third person[s] who [are] liable for injury or disease....either alone or in conjunction with the injured or diseased person...." we see little chance that a court would dismiss or rule in summary judgment against a fed claim.

3. There is confusion about the nature of the fed's lawsuit, which will seek recovery of federal spending on smoking-related diseases under Medicare, Veterans, and other federal programs. DOJ's lawsuit will not seek recovery for the fed's share of state Medicaid spending, which was the basis for the AG settlement. Some analysts have misinterpreted Janet Reno's 1997 quote that the federal government does not have authority to seek recovery as applying to Medicare, when, in fact, she was referring to Medicaid.

4. Conceptually, the federal settlement vehicle pitched by Scruggs,

combined with the AG settlement, would get the industry close to the legal certainty envisioned by the June 20 accord. The industry would demand offsets (i.e. credits) for personal injury judgments (individual, consolidated, classes), international judgments, third party recovery judgments not in the AG settlement, and excise tax hikes for a finite number of years. New settlements might be granted only a partial offset, to encourage a defense.

5.We expect the industry to cede limited FDA jurisdiction -- which could be the hook that convinces the health community to get behind a new settlement. Last year, the 4th Circuit rejected the Administration's en banc request to review the three-judge panel's ruling that the FDA had no authority to assert jurisdiction. The U.S. Supreme Court has been asked to review the matter.

6.The biggest obstacle to a new deal remains renegade pricing. The AG settlement gave the renegades a $.45/pack cost advantage as long as their share didn't exceed the higher of 125% x 1997 share, or 1998 share. A $150-$200 billion federal settlement ($7-$8 billion/year) would give the renegades an additional $.35/pack cost advantage. Because share caps would remain fixed, the practical volume upside for the renegades with an $.80/pack cost advantage is not that different than with a $.45/pack advantage.

7.A DOJ settlement would not require Congressional approval, and would likely be welcomed by Republicans who oppose both raising excise taxes and efforts by the Administration to take its average 60% share of the state AG settlements. Yesterday, Senators Gramm (R-FL) and Hutchison (R-TX) announced they would introduce legislation to block the Administration from taking any of the state Medicaid settlement proceeds. Risk: This could become a "Christmas tree" for other tobacco initiatives.

INVESTMENT CONCLUSIONS

We rate Philip Morris, RJR, and UST outperform. We expect tobacco stocks to remain weak near-term, given the odds of losing at least one of the four trials ongoing in February (Henley in California; Engle Phase I in Florida; Newcombe/Karney in Memphis; Ohio Iron Workers). Over the next few months, however, we expect stocks to rally as investors start to discount that the industry will again attempt to bring closure to this seemingly endless spiral of litigation, by constructing a federal settlement vehicle that essentially caps the legal risks not covered in the new AG settlement. Our simple premise: Once the industry has decided to settle, it cannot suddenly change course and decide to fight. We also perceive that investors are overlooking two fundamental issues that could trigger positive revisions: One, the 1999 consumption declines associated with the $.45/packprice hike taken at the end of 1998 are likely to be about half the 10-12% declines predicted by management and other analysts. Second, BAT's purchase of Rothmans, which we expect will trigger a global consolidation wave, will improve global pricing, leverage distribution, and be accretive if funded with debt.

Tob-xr-industry performance

and

Tob-state settlements

Bruce N. Reed
10/01/98 11:13:30 AM

Record Type: Record

To: Elena Kagan/OPD/EOP, Cynthia A. Rice/OPD/EOP

cc:
Subject: rjr worth more dead than alive

RJR: Russia's Problems Don't Change Odds of Spinoff. The Coming Proxy Fight. Outperform.

Gary Black (212) 756-4197
Jon Rooney (212) 756-4504

September 30, 1998

TOBACCO

HIGHLIGHTS

1.We have cut RJR estimates to $2.20 in 1998 (from $2.40; we had previously quantified exposure of $(.15)/share in Russia), and to $2.40 in 1999 (from $2.50). Our going forward assumption is that Russia wi generate zero profits in 1998, and $10-$15 million in 1999. With no profits in low-tax Russia, management has increased its estimated 1998E tax rate to 45.5%, from 43.0%.

2.The estimate cut, which was largely expected, was offset by news that 3Q domestic tobacco profits will b up about +10% (+4-5% previously expected) on an approximate (7%) volume decline (industry -6%; reflects trade deloading following Spring price increases). This suggests that RJR, following B&W's lead, is finally cutting back on promotional spending behind Doral.

3.We do not expect RJR to cut its dividend (1998 dividend $2.05, vs. $3.75 cash earnings, 55% payout; M 52% payout; UST 65% payout) until Nabisco is spun off (early-1999). Our standalone RJR Worldwide Tobacco 1998E estimates are now $1.45 reported EPS ($1.55 in 1999), $2.55 cash EPS ($2.70 in 1999), 1998E fixed charge coverage of 3.1x (3.3x in 1999).

4.The estimate cut does not change prospects for a spinoff of Nabisco. In fact, the continued terrible operating results at both RJR International and Nabisco, combined with our view that raider Carl Icahn (13-14MM shares) will announce another proxy fight to unseat management (filing deadline Nov. 26), increases the pressure on RJR to spin out Nabisco once there is a new AG deal.

5.We believe the market has overreacted to what is old news, especially when one considers that RJR likely has no choice but to find an international partner to beef up distribution and management. With a 35% cut in RJR estimates since beginning of the year, shareholders have lost faith in management's ability to fix RJR's problems, and should increasingly attach a change in control premium to RJR's shares. If Icahn attracts as a partner a strong consumer products veteran, he could get 60% + of the proxy vote.

6. While Philip Morris does not appear to be having anywhere near the same problems that RJR is having in Russia -- much better management team and local distribution -- we have said that we would cut $.05/shar out of our Philip Morris 1998 numbers (to $3.10) if PM told us that its Russian profits were zero ($150 million current estimate -- about 3% of PM International)

7. Settlement update: We believe the key obstacle holding up the deal is the parties' intent to make sure that "substantially all" of the AGs opt-in to the deal once it is announced (Friday or next Monday is our best bet). We have heard that the opt-in period for the AGs will be relatively short -- likely 7-10 days from day of announcement. We have also heard that there will some monetary incentive that RJR and B&W (portion of upfront payments borne by MO) forfeit if they fail to sign up during the opt-in period.

INVESTMENT CONCLUSIONS

We reiterate our outperform rating. Assuming there is a new AG agreement, we see little downside for RJR, even with continuing problems in Russia. Either one of two outcomes seems likely: One, RJR will enter into the AG settlement, spin off Nabisco, and shareholders will be rewarded with a sum-of-the-parts valuation (estimate $40 -- RJR's stake in Nabisco is now worth $23.75 per share. Even with the estimate cut, RJR's worldwide tobacco business ($1.45 in reported EPS and $2.55 in cash EPS), is worth potentially $15 - $18 per share, at 10 - 12x reported earnings, or 6-8x cash earnings). If RJR elects not to join the settlement, which would suggest no spinoff, we have no doubt there would be a change in control at RJR next year as shareholders elect to unseat the current Board and management. In the latter situation, we would expect the new Board to adopt the settlement put in place by Philip Morris and Loews, install a new management team that can fix RJR International, and move to unlock value via spinoffs, asset sales, etc. That said, we still prefer Philip Morris and UST over RJR, which is likely worth more dead than alive. Our price target remains $40.

11/03/97 MON 11:34 FAX

Tobacco-settlement - antitrust

and

Tobacco-settlement - industry performance

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October 31, 1997

The Honorable Orrin G. Hatch
United States Senator
Chairman, Committee on the Judiciary
United States Senate
Washington, D.C. 10610-6275

Dear Senator Hatch:

At the October 29, 1997 hearing of the Subcommittee on Antitrust, Business Rights and Competition, you asked for Philip Morris's estimate of the retail price of cigarettes in 2002 and 2007 that would result if the national tobacco settlement as proposed on June 20 were enacted into law.

Philip Morris's estimate is that the retail prices of cigarettes will rise in nominal terms by an absolute minimum of \$1.20/pack by 2002 and \$1.52/pack by 2007, reflecting increases of 66% and 84% respectively over present average prices.

In real terms, i.e., expressed in 1997 dollars, the retail price increases will be a minimum of \$1.06/pack in 2002 and \$1.19/pack in 2007, reflecting increases of 58% and 65% respectively.

The retail price structure is set forth below:

($/pack)	August 1997	2002	2007
On-going Settlement[1]	--	0.72	0.83
Industry Price[2]	0.83	0.97	1.13
Federal Excise Tax[3]	0.24	0.39	0.39
State Excise Taxes	0.33	0.33	0.33
Trade Margin	0.34	0.48	0.51
Sales Tax[4]	0.08	0.13	0.15
Total	1.82	3.02	3.34
Increase Versus August Retail Price			
$		1.20	1.52
%		65.9%	83.5%

Philip Morris believes that the foregoing estimates are conservative as they exclude the following:

- any increases in state excise taxes which have historically risen at an annual rate of approximately 5%.
- any price increase to reflect the imposition of surcharges that would result from failing to meet specified youth smoking incidence reduction targets.
- any price increases to reflect the industry's obligations with regard to defense costs and those judgment or settlement costs which remain the obligation of the industry and plaintiffs' attorney's fees.

Finally, in the estimate, the wholesaler and retailer margins expressed as a percentage of retail price are projected to decline from a prevailing level of 19% to 16% in 2002 and 15% in 2007.

The Philip Morris estimate may also be compared with the estimates of Wall Street analysts who are projecting retail price

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[1] Reflects on-going payments inflated at the minimum escalator of 3%.
[2] Assumes industry price will increase by an annual inflation rate of 2.5%.
[3] Reflects an increase in the federal excise tax of $0.10/pack in 2000 and $0.15/pack in 2002.
[4] Reflects prevailing national average tax of 4.7%.

increases in real terms, i.e., expressed in 1997 dollars, of between $1.10/pack and $1.18/pack by 2002 and $1.50/pack and $2.02/pack by 2007. Thus, according to these analysts, the terms of the proposed national tobacco resolution, as they currently stand, would increase the real retail price of cigarettes by up to 65% in 2002 and 111% by 2007.

At the same hearing you also requested our proposed language for the antitrust exemption. I am enclosing our proposed draft language for such an exemption.

Please let me know if I can be of any further assistance.

Sincerely,

Meyer G. Koplow

MGK/tv

SEC. 802. LIMITED ANTITRUST EXEMPTION.

(a) The federal antitrust laws and any similar law of any State shall not apply to any joint discussion, consideration, review, action or agreement by or among any participating manufacturers, or any individuals acting on behalf of any participating manufacturers, for the purposes of, and limited to —

(1) entering into the Protocol or a Consent Decree;

(2) refusing to deal with a distributor, retailer or other seller of tobacco products that distributes such products for sale to, or offers for sale or sells such products to, underage persons, or that otherwise fails to comply with applicable requirements of the Act, the Protocol or the Consent Decrees; or

(3) submitting an application relating to, entering into, or complying with or otherwise carrying out the terms of any plan or program that has been approved under subsection (b) of this section.

(b) The Attorney General of the United States is authorized to approve upon application of one or more participating manufacturers plans or programs to reduce the use of tobacco products by underage persons. Prior to approving any such plan or program, the Attorney General shall determine that approval is appropriate as part of the effort to reduce the use of tobacco products by underage persons and will not have the effect of unduly restraining competition. Any such application shall be approved or disapproved in writing within 90 days from the date of submission to the Attorney General. Upon written withdrawal by the Attorney General of any approval hereunder, the provisions of paragraph (a)(3) of this section shall not apply to any subsequent act or omission to act by reason of such approval.

Bruce —
Did you see?
Elena

Tobacco - settlement -
industry performance

The New York Times
THURSDAY, SEPTEMBER 25, 1997

Economic Scene | Peter Passell

Tobacco might thrive with a $1.50-a-pack rise for cigarettes.

IS the tobacco industry playing Brer Rabbit to President Clinton's Brer Fox? The President's assertion that if necessary, the price of cigarettes should rise by $1.50 a pack to deter teen-age smoking evoked bitter denunciations from Big Tobacco. "The industry should be not held solely accountable for social behavior that neither it, nor the Government, can control," read the cigarette manufacturers' collective response.

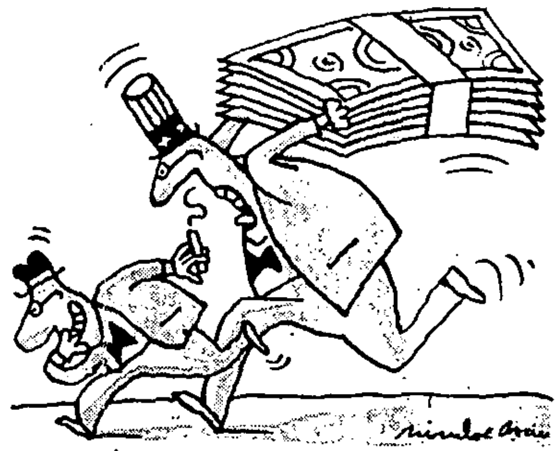
But a close look at Mr. Clinton's demands suggests that the industry could live — conceivably thrive — with the consequences. Jeremy I. Bulow, an economist at the Graduate School of Business at Stanford University, calculates that a settlement on the President's terms would cost the tobacco companies less than the continuing uncertainty over legal liability. "The best estimate now is that $1.50 a pack would increase the market value of tobacco stocks," Mr. Bulow argues.

• • •

"Reducing youth smoking is the Administration's bottom line," President Clinton said. "One of the surest ways" to meet the Administration's goal of a 60 percent cut in teen-age smoking over a decade, he added, is to "increase the price of cigarettes."

Since teen-agers have less money than adults and are not yet addicted to nicotine, their consumption of tobacco is more responsive to price changes than that of adults. Nonetheless, to cut teen-age smoking by 60 percent would probably require a $1.50 price increase.

The combination of taxes and penalties built into the original settlement proposal — a proposal the Federal Trade Commission staff argued this week could actually increase industry profits — totaled 72 cents a pack. When a reporter asked Bruce N. Reed, director of the President's Domestic Policy


Nicolae Asciu

Council, whether the Administration's approach would double the 72-cent penalty, Mr. Reed said it would. That, in turn, led to the speculation that the President's approach would have doubled the cost of the original settlement, to about $700 billion.

But Martin Feldman, a tobacco industry analyst at Smith Barney, begs to differ. He notes that the 72 cents does not include the 15-cent-a-pack increase in the Federal excise tax on the books for the year 2002. Nor does it include future increases in state taxes, or in markups by retailers. All told, Mr. Feldman estimates that the abandoned settlement would have raised the price of a pack by $1.45 in just five years — almost as much as the President's proposed maximum increase over a decade.

Mr. Bulow of Stanford expects there is more daylight between the cost of the two proposals than Mr. Feldman argues because competition would prevent retailers from fattening their markups significantly. Nonetheless, the university economist is confident that cigarette makers could live with measures that would increase the supermarket price by $1.50 a pack.

Mr. Bulow's conclusion is based on the idea that the cigarette makers' goal is to maximize the total return for stockholders. He cites estimates by Gary Black, a tobacco analyst at Sanford C. Bernstein, that the domestic tobacco businesses of Philip Morris and RJR Nabisco are currently valued by the market at just one-third what they would be worth in the absence of uncertainty about future litigation and regulation.

He estimates that a tax of $1.50 a pack would reduce cigarette consumption by about one-third. The lost sales would mean a more-than-proportionate fall in profits, but Mr. Bulow estimates that part of the costs of the settlement would be recouped since marketing costs would also fall. On balance, he calculates that a $1.50 tax would pare the industry's $5 billion annual profit by a bit less than half.

• • •

That is hardly what the cigarette companies hoped for. But Mr. Bulow reckons that it is better than living with the current level of legal uncertainty, which has reduced the market value of the business by two-thirds. And since the Administration appears eager to set goals in terms of reduced youth smoking, rather than reduced smoking over all, the companies may find ways to salvage a portion of the lost profit.

For example, Mr. Bulow expects that an increase in the minimum legal smoking age to, say, 19, would deter teen-age smokers, yet have little effect on adults in the near term. So by supporting tougher restrictions on access to cigarettes, the companies might get away with a smaller tax that cut less deeply into profits from sales to adult addicts.

Concentrating on youth smoking directly has a social advantage, too. Smokers, on average, have lower incomes than nonsmokers. So relying more on direct regulation of youth smoking and less on cutting demand with across-the-board price increases reduces the regressivity of the policy. "It would be a shame to put most of the burden of the antismoking settlement on the backs of adults earning less than $10 an hour," Mr. Bulow said.

CREDIT MARKETS

Many Factors Prompt Rise In Bond Prices

Borrowing by U.S. Might Be Reduced

By ROBERT HURTADO

Treasury prices turned sharply higher yesterday, as market participants weathered the Treasury's auction of new five-year notes and reacted to a number of other factors including a report that the Government was likely to curtail its borrowing needs in the coming fiscal year.

At the shorter end of the curve, the shorter-maturity bills again made strong gains as the end-of-quarter buying continued. The rate on three-month bills dropped eight-hundredths of a percentage point, to 4.77 percent.

The 30-year bond gained nearly a full point, up 30/32, to a price of 100 27/32. The bond's yield, which moves in the opposite direction from the price, fell to 6.31 percent, from 6.38 percent on Tuesday and the lowest since 6.29 percent on July 29.

Ahead of the five-year sale, interest by smaller investors was seen at the 6 percent level, as dealers tried to discount the note further to quicken its sale and distribution, not wanting the auction to be as disappointing as the two-year note auction on Tuesday.

James Padinha, an economist at Briefing.com, a market analysis firm in Menlo Park, Calif., said the auction results were not exceptional. "Building into the auction, however, if you wanted to play the momentum you were fine," he said. "If you were playing the trading view, maybe you were O.K., and if you were taking the fundamental view, no way."

At the Treasury's $11.5 billion auction yesterday, the new five-year notes were sold at the high yield of 5.960 percent, the lowest since 5.950 percent on Nov. 26, 1996.

Barry Evans, senior vice president and portfolio manager at John Hancock Funds, said: "With rates nearing the lows of the year, I think buyers of mortgage-backed securities are anxious about a potential wave of refinancing. To calm their anxiety, they are chasing the five-year notes."

Other factors behind the market increase included short-covering following talk of hedge fund and central bank buying. Short-covering occurs when speculators, who sell borrowed securities in hopes of buying them back later at lower prices, are forced to scramble and buy back the securities before they incur losses when the market moves up. There was also some hope that the Fed would come to market to do a coupon pass, that is come in as a buyer of various maturities.

Government securities were also bolstered from a Market News Service story that focused on the improved Federal budget outlook and how it would probably curtail the financing needs of the Treasury beginning in October, the start of the Government's new fiscal year.

Any reduction in financing needs by the Government is seen in the long run as increasing prices and lowering yields.

Robert Pugliese, senior vice president and director of the fixed-income department at J. W. Charles Securities Inc. in Boca Raton, Fla., said he saw the signs of a large hedge fund buying as well as central bank buying. "Based on the current rate of inflation, the real rate of a 30-year bond, which is the nominal rate minus inflation, should be 5.50 percent," he said.

Even with all the strong buying the market was unable to break through some strong overhead resistance, said Doug Burtnick, managing analyst with Technical Data of Boston. "You can't argue with the fact that the longer-term prospects still look constructive or that both the investment and dealer communities are looking for opportunities to trade from the long side."

The following are the results of yesterday's Treasury auction of new five-year notes:

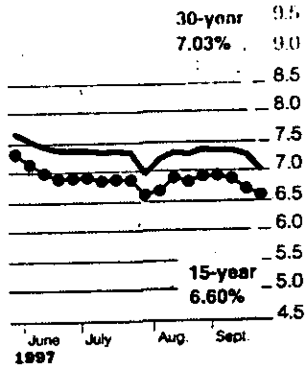
(000 omitted in dollar figures)

High Price	99.637
High Yield	5.960%
Low Yield	5.900%
Median Yield	5.945%
Accepted at low price	39%
Total applied for	$35,373,148
Accepted	$12,783,978
Noncompetitive	$911,236
Interest set at	5 7/8%

The five-year notes mature Sept. 30, 2002.

Freddie Mac Yields

Average weekly yields on Federal Home Loan Mortgage Corporation 30-year and 15-year participation certificates, in percent. Yields track changes in fixed-rate mortgages.



Source: Federal Home Loan Mortgage Corp.

The New York Times

Key Rates

In percent

	Yesterday	Previous Day	Year Ago
PRIME RATE	8.50	8.50	8.25
DISCOUNT RATE	5.00	5.00	5.00
FEDERAL FUNDS*	5.63	5.45	5.56
3-MO. TREAS. BILLS	4.77	4.85	4.90
6-MO. TREAS. BILLS	4.93	5.01	5.06
10-YR. TREAS. INFL.**	3.56	3.57	N.A.
10-YR. TREAS. NOTES	6.03	6.09	6.68
30-YR. TREAS. BONDS	6.31	6.38	6.92
TELEPHONE BONDS	7.40	7.49	7.98
MUNICIPAL BONDS***	5.45	5.46	5.92

*Estimated daily average, Dow Jones Markets
**Realized dollar amount rises with inflation
***Municipal Bond Index, The Bond Buyer
Sources: Salomon Brothers and Dow Jones Markets for Treasury's bellwether bonds, notes and bills

CURRENCY MARKETS

Dollar Tumbles Against Yen On Warning About Group of 7

By The Associated Press

The dollar dropped sharply against the yen yesterday after an influential Japanese official said that the market had underestimated the warning by the Group of Seven countries against a weaker yen.

The dollar also tumbled against the mark after Germany's top central banker said the bank would try to keep the mark from falling further.

"It's a realization on the part of traders that the G-7 is not continuing to allow the dollar to run up against the yen and the mark," Robert Brusca, chief economist at Nikko Securities International, said.

Last weekend, finance chiefs of the Group of Seven industrial nations at a gathering in Hong Kong said that the group would not welcome further weakening of a currency that would lead to wider trade imbalances.

Traders initially brushed off the comments as too general and bought dollars, despite recent concerns about the role of the weak yen in Japan's growing trade surplus.

But Japan's vice finance minister of international affairs, Eisuke Sakakibara, said early yesterday that the market failed to understand that "the G-7 statement was very strong on the dollar-yen relationship."

The comments produced fears that Tokyo or Washington would intervene in the foreign exchange markets to strengthen the yen.

That sent the dollar plunging to a low of 119.40 before it settled in late New York trading at 120.40 Japanese yen, down from 122.13 late Tuesday.

The dollar also fell to 1.7727 marks from 1.7934 marks. The British pound rose to $1.6142 from $1.6137.

The market was especially vulnerable to the comments of Mr. Sakakibara because many traders had been betting that the dollar would rise, Graham Broyd, a senior vice president at NatWest Markets, said.

Against the mark, the dollar tumbled after the president of the Bundesbank, Hans Tietmeyer, was quoted as saying that the central bank would do everything in its power to prevent the mark from falling too far against other currencies.

The comments reversed a recent rally in the dollar on economic data that suggested German inflation was not growing fast enough to merit an interest rate increase by the Bundesbank to control inflation. Mr. Tietmeyer's comments revived fears that the Bundesbank would raise interest rates.

FUTURES MARKETS

Soybeans Higher as Demand For American Harvest Grows

By The Associated Press

Soybean prices rose sharply yesterday on the Chicago Board of Trade as world demand for the United States crop began to increase and remnants of Hurricane Nora threatened to slow early harvesting.

On other markets, cocoa rose amid indications that dry weather in the Ivory Coast and Ghana has severely curtailed production, while precious metals advanced.

Forecasters say the remnants of Hurricane Nora could reach up into Midwest growing regions early next week, delaying early soybean harvesting and halting new supplies that are needed to refill empty coffers.

There are early signs that even a record crop, as expected by the Agriculture Department, may not meet what is expected to be peak world demand.

Soybean production is forecast at 2.75 billion bushels, but nearly every bean will be needed to rebuild inventories that fell to a 20-year low of 115 million bushels before Sept. 1.

The United States, Argentina and Brazil combine to produce the bulk of the world's soybeans, but most of the South American harvest is shipped when American soybeans are growing. Around year-end, United States producers generally are the only big suppliers of soybeans.

Argentina already is importing United States soybeans, with 180,000 tons ordered for the November-December period. Tunisia also bought European rapeseed oil and sunflower oil, two oils similar to soybean oil.

Drought attributed to the El Niño warming trend in Asia and Indonesia also could reduce those countries' palm oil production and lead to greater soybean-oil imports there, said Dan Cekander, an analyst with Fimat Futures USA Inc. Palm oil is a competing vegetable oil.

Soybeans for November delivery rose 7.25 cents, to $6.3825 a bushel.

Cocoa futures rose sharply on the Coffee, Sugar and Cocoa Exchange in New York as early harvesting of the Ivory Coast's crop brought only a trickle of supplies to market, suggesting production there has also been curtailed by El Niño.

The severity of the drought is unclear, though exchange warehouse supplies are 15 percent below levels of a year ago. December cocoa rose $33, to $1,691 a ton.

The New York Times
THURSDAY, SEPTEMBER 25, 1997

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October 8, 1997

The Honorable Kent Conrad
United States Senate
SH-530 Hart Senate Office Building
Washington, DC 20510-3403

Dear Senator Conrad:

Enclosed is the response from Lorillard Tobacco Company, Philip Morris Companies Inc., R. J. Reynolds Tobacco Company and UST, Inc. to your request for a financial analysis of the impact on the industry of the proposed resolution. Brown & Williamson Tobacco Company will be providing you with a supplement within the next day or so.

Please let me know if I can be of additional service to you and/or members of the Task Force.

With kindest regards.

Sincerely,

Phil Carlton

Phil Carlton

Enclosure

JPC:cda

Impact of the Proposed Resolution on the U.S. Cigarette Industry

The Conrad Senatorial Task Force has requested the industry to estimate the impact of the proposed resolution on cigarette consumption in the U.S. and its potential effect on individual tobacco company stock prices. This paper attempts to respond to this request despite the significant uncertainties associated with these topics.

Cigarette Consumption

There has been much speculation on the impact of the proposed resolution on the level and nature of future cigarette consumption in the U.S. Any projection is a perilous exercise, but in this specific instance, it is particularly difficult to predict with any degree of confidence the proposed resolution's effect on cigarette consumption. This inherent uncertainty arises from the unprecedented magnitude and scope of the combined impact of the numerous economic and non-economic measures contained in the proposed resolution.

Cigarette consumption in the U.S. is estimated to have reached a level of 482.7 billion units in 1996 reflecting an annual average decline of 1.3 percent since 1990.[1]

Cigarette consumption levels are a function of numerous parameters and their interrelationships. These parameters include price, price gaps, the availability of substitute products, demographics, inflation, consumer disposable income, social attitudes towards smoking, smoking restrictions, etc. Many of these parameters are subject to considerable uncertainty and will be significantly impacted by the proposed resolution.

Economists measure the impact of real price movements on the purchase of any product through econometric modelling which yields a price elasticity ratio. For example, a price elasticity ratio of -0.5 means that a real price increase of 10 percent generates a reduction in demand of 5 percent. Numerous studies have been conducted that estimate the price elasticity of demand for cigarettes in the U.S. market. The vast majority

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[1] Industry estimates of consumption derived from industry shipments adjusted for trade inventory movements.

suggest that elasticity falls between -0.40 and -0.45.[2] These studies rely on historical data to measure elasticity and generally derive estimates based on "short run" or immediate impacts. Some studies have attempted to measure the "long run" elasticity of demand for cigarettes. A study by Economics Nobel Prize laureate, Gary Becker, estimated that the long run response to a permanent change in price falls between -0.73 and -0.79 with an average elasticity factor of -0.75.[3] The Becker study implies that a 10 percent increase in real prices will cause a short run decrease in cigarette sales of approximately 4 percent and a long run decrease in cigarette demand of 7.5 percent.

A March 1994 analysis by Gravelle and Zimmerman of the Congressional Research Service[4] also highlights the fact that the expected long run reduction in demand for cigarettes will be much greater than in the short run. The study implies that the long run elasticity could be as high as -1.2. Thus, under this measure, a 10 percent price increase would result in a long run decline in cigarette sales of 12 percent.

Price elasticity of demand is not independent of real price movements. When consumer prices reach unprecedented levels, sensitivity to price also rises and thus elasticity ratios become more pronounced. Accordingly, the industry conservatively estimates that as a result of the real retail price increases that will result from the implementation of the proposed resolution, price elasticity is likely to fall between -0.5 and -0.75.

U.S. cigarette consumption is estimated to have a negative annual underlying trend, independent of real price movements, of between 1 percent and 2 percent.[5] The proposed resolution incorporates a wide array of measures which will clearly impact this underlying trend in demand. These measures include access restrictions, well funded public education campaigns and billions of dollars earmarked for cessation programs. While it is difficult to predict in an accurate manner the extent to which the underlying negative trend will accelerate, it can safely be assumed that at a very minimum it will increase to a range of between 2 percent and 3 percent.

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[2] 1989 Surgeon General Report, Table 12 on Page 535.
[3] Becker et al, Analysis of Cigarette Addiction, the American Economic Review, June 1994, Volume 84, No. 3, Page 407, Table 4.
[4] Gravelle and Zimmerman, Cigarette Taxes to Fund Health Care Reform: An Economic Analysis, March 8, 1994, Congressional Research Service, The Library of Congress.
[5] Patrick Fleenor, Tax Foundation - The Effect of Excise Tax Differentials on the Interstate Smuggling and Cross-Border Sales of Cig, arettes in the U.S., October 1996, as well as industry estimates.

In recent weeks the public health community and numerous officials have stated that retail prices will increase by 62 cents per pack by the fifth year of implementation of the proposed resolution. This number is grossly underestimated. For example, it totally ignores the multipliers inherent in the retail price structure of cigarettes, e.g., trade margins and state and local general sales taxes. The industry conservatively estimates that retail prices will increase by an absolute minimum of $1.20 per pack by the fifth year and by an absolute minimum of $1.50 per pack by the tenth year of implementation of the proposed resolution.[6] Accordingly, retail prices will rise at least to the levels that are being advocated by the public health community and the President without the imposition of any additional Federal or State excise taxes.[7]

The following table highlights cigarette demand levels that are derived from price elasticity factors of -0.5 and -0.75 and a downward underlying trend in demand of 2.5 percent:

Table 1

Projected Cigarette Consumption
1997 - 2007
(Billion Cigarettes)

				% Variance	
Elasticity	1997	2002	2007	2002 vs. 1997	2007 vs. 1997
-0.50	477.0	337.8	301.1	(29.2)%	(36.9)%
-0.75	477.0	300.6	269.3	(37.0)%	(43.5)%

Over a ten year period it is estimated that cigarette consumption would fall by between 175.9 billion cigarettes and 207.7 billion cigarettes versus 1997 estimated consumption of 477 billion cigarettes.

Table 2 highlights the above-mentioned projections versus cigarette consumption levels that would otherwise have materialized as a result of the secular downward trend of approximately 1.5 percent:

[6] See detailed retail price projections on Table 5, Page 9.
[7] Over and above the prevailing average State Excise tax of $0.33/pack and the $0.39/pack Federal Excise tax as of 2002.

Table 2

Projected Cigarette Consumption
1997 - 2007

(Billion Cigarettes)

	1997	2002	2007
Base	477.0	442.3	410.1
Scenario 1	477.0	337.8	301.1
Scenario 2	477.0	300.6	269.3
% Variance Versus Base:			
Scenario 1	-	(23.6)%	(26.6)%
Scenario 2	-	(32.0)%	(34.3)%

Such volume declines will have a significant adverse impact on the entire cigarette supply chain. Industry pretax earnings will suffer even if unit margins rise to offset the higher burden of unit fixed costs in the face of declining sales volumes.

The Federal Trade Commission has recently issued a report that alleges that the industry could reap substantial benefits from the proposed resolution.[8] Indeed, the FTC report claims that the industry could raise prices with impunity and thereby generate huge windfall profits. The report also claims that the industry would retain two thirds of incremental revenues to the detriment of the public sector. The report's analysis and conclusions are seriously flawed for the following reasons:

(i) The report erroneously assumes that increases in the retail price of cigarettes beyond the level required to pass through the settlement payments will accrue solely to the manufacturers. For example, under the FTC report's "200% scenario" which entails a retail price of $3.04/pack, the FTC report assumes that

[8] Federal Trade Commission, Competition and the Financial Impact of the Proposed Tobacco Industry Settlement, September, 1997.

the manufacturers' price[9] net of taxes and settlement payments will be $1.42/pack. As highlighted on Table 3, had the FTC used more accurate assumptions in its projections, it would have concluded that the manufacturers' price would be significantly lower than its study suggests under its retail price assumptions.

Table 3

($ / pack)	200% Price Increase 2007 FTC Projection	Amended FTC Projection[10]
Retail Price	$3.04	$3.04
Federal Excise Tax[(a)]	(0.24)	(0.39)
State Excise Tax	(0.32)	(0.33)[(b)]
Settlement Payment[(c)]	(0.62)	(0.83)
Trade Margin	(0.44)[(d)]	(0.58)[(e)]
Sales Tax at 4.7%	–	(0.14)
Manufacturers' Price	$1.42	$0.77

(a) After the publication of the report, the FTC stated that the $0.15/pack excise tax credit ($0.10/pack in 2000 and $0.05/pack in 2002) should not have been factored into its assumptions.

(b) The weighted average state excise tax prevailing in July 1997 was $0.3362/pack reflecting increases in New Hampshire, Utah and Rhode Island.

(c) The minimum 3 percent per annum escalator is omitted by the FTC.

(d) The FTC report does not explicitly divulge the trade margin assumption. The trade margin is derived from the FTC report by deduction and is consistent with the theory expounded in the report that any increase in retail price accrues solely to the manufacturers.

(e) This conservatively assumes that the trade will earn a margin of only 12 percent on any increase in retail price beyond the $1.90/pack .

For perspective, it should be highlighted that the average manufacturers' net selling price in 1996 was $0.80/pack.

[9] Manufacturers' price to wholesalers.
[10] It follows from this analysis that the retail price would have to be $3.81/pack to yield a manufacturers' price of $1.42/pack.

(ii) The assumptions pertaining to industry profitability are simplistic at best.

The FTC report uses a weighted average operating profit of $0.32/pack. The Brown and Williamson Tobacco Corporation (B&W) which accounted for 17.2 percent of industry sales volume in 1996 is omitted from this calculation. Had the FTC report included B&W's operating profits in the weighting, the average operating profit would decline to $0.30/pack, a difference of $500 million dollars in annual industry pretax earnings.

The report fails to specify that a significant proportion of the industry's cost base is composed of fixed costs, i.e., costs that are independent of throughput along the entire supply chain. The report simply assumes that all industry costs are variable. In other words, the FTC assumes that all fixed costs will decline in line with projected volume declines. Under the FTC's premise, a sales volume loss of one billion cigarette packs would erode industry profits by $300 million dollars. In fact the loss would be more than double this level, as fixed costs will remain and the industry would lose the full marginal contribution generated by this volume, i.e., approximately $640 million dollars.

The report admits that in order to "simplify the analysis" it ignores the potential impact of a change in mix, i.e., a potential shift in demand from premium priced brands to either discount or generic products. Premium brands currently account for approximately 72 percent of total sales. For purposes of illustration, should this segment decline to a level of 60 percent with a corresponding increase in the discount segment, the net cost to the industry would be in excess of $600 million in operating profits at prevailing unit margin levels.[11]

The FTC report estimates potential marketing and legal expenditure savings that ostensibly would be derived from the implementation of the proposed resolution. It is by no means certain that the industry will in fact generate savings in its legal expenditures. The FTC fails to take account of the industry's continued exposure to individual litigation and to its obligations in terms of attorneys' fees. Moreover, the FTC fails to account for any cost increases associated with the proposed resolution. It notably omits from its assumptions:

- the interest costs related to the industry up-front payment of $10 billion.

[11] A shift in consumption to the discount segment will result in a lower average retail price than otherwise would be the case and hence volume would be marginally higher. The resulting higher volume would only partially offset the significant margin erosion resulting from an adverse change in mix.

- the significant expenditures required to fully comply with the broad array of regulatory measures that are contained in the proposed resolution.

- the implications of the proposed resolution on the cost of tobacco. Future legislation will in all likelihood contain provisions designed to protect domestic tobacco growers and their communities from the impact of declining volumes. These provisions are likely to increase the direct or indirect cost of tobacco.

- any potential surcharge that would be imposed on the industry in the event that underage smoking incidence would fail to meet the reduction targets that are specified in the proposed resolution.

(iii) The report chooses to neglect the historical pattern of state excise tax increases which have risen at an annual average rate of approximately 5 percent since 1990. It is simply unrealistic to assume that both the Federal Excise Tax and State Excise Taxes will remain at current levels for the next 25 years if industry profitability should ever reach the unprecedented levels that are suggested by the FTC report.

<u>Company Share Prices</u>

The inherent uncertainty pertaining to the impact of the proposed resolution on the level and nature of future cigarette consumption and on industry profitability also clearly applies to the reaction of the stock market.

It is an indisputable fact that the stock prices of tobacco companies historically have been volatile and that the relative Price/Earnings ratios of these companies have been adversely impacted by the threat of litigation, despite the fact that the industry has consistently prevailed in the courts.

There are those on Wall Street who believe that the elimination of substantial event risk provides predictability and thus should be a net positive for the tobacco companies. They claim that these companies are all highly diversified and thus the market discount afforded to these non-tobacco assets would be removed.

Conversely, there are others on Wall Street who believe that the proposed resolution will be a net negative for the tobacco companies. They believe that the terms of the resolution are too onerous and that these companies can sustain their successful track record in the courts. Moreover, they argue that any potential expansion in their respective Price/Earnings ratios would be fully offset by the erosion in profitability that these companies will incur as a result of the resolution.

The fact of the matter is that no one is in a position to predict what may happen to individual stock prices.

Table 4 highlights the performance of individual stock prices versus the S&P 500 at market close on September 25, 1997:

Table 4

	September 25, 1997 Stock Prices		
	Year-End 1995	Year-End 1996	P/E Ratio
BAT Industries	(7.7)%	8.2%	11
Loews	42.8%	18.8%	14
Philip Morris Companies	38.0%	10.2%	15
RJR Nabisco	8.3%	(2.0)%	13
S&P 500	53.4%	21.7%	24

Table 4 clearly highlights that the stock market's reaction to date to the terms of the proposed resolution has been negative as every single company has trailed the S&P 500 since both year-end 1995 and year-end 1996 despite solid profit growth and attractive dividend yields.

Wall Street is oriented towards the short term, and the bulk of the projections emanating from Wall Street focus on a period of only 3 years and, in some rare instances, 5 years. In addition, in a bull market everything is viewed optimistically. The long term impact remains uncertain and will depend on each individual company's ability to generate earnings growth through its other businesses.

Table 5

Minimum Retail Price Projections[1]
($ / pack of 20 Cigarettes)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
On-going Settlement Payments [a]	-	0.360	0.414	0.517	0.647	0.715	0.737	0.759	0.782	0.805	0.829
Industry Price [b]	-	0.027	0.054	0.082	0.111	0.141	0.171	0.202	0.234	0.267	0.300
Federal Excise Tax	-	-	-	0.100	0.100	0.150	0.150	0.150	0.150	0.150	0.150
Trade Margin [c]	-	0.053	0.064	0.095	0.117	0.137	0.144	0.152	0.159	0.167	0.174
Sales Tax [d]	-	0.021	0.025	0.037	0.046	0.054	0.056	0.059	0.062	0.065	0.068
Total Increase	-	0.461	0.557	0.831	1.021	1.197	1.258	1.322	1.387	1.454	1.521
Retail Price	1.82[e]	2.28	2.38	2.65	2.84	3.02	3.08	3.14	3.21	3.27	3.34

[a] Reflects on-going settlement payments adjusted for volume and indexed at minimum annual rate of 3%.
[b] Only reflects adjustment for inflation of 2.5%.
[c] Assumes a combined 12% rate for both wholesalers and retailers. Current average trade margin, expressed as a percentage of retail price, exceeds 20% and thus this assumption is extremely conservative.
[d] Reflects national average tax of 4.7%.
[e] Average weighted net price to consumer.

[1] These projections exclude any additional federal or state excise taxes and any additional payments that may be required under the terms of the proposed resolution, e.g., surcharges pertaining to the lookback provision.

Tobacco -
settlement -
industry
performance

Legal Affairs

TOBACCO

COSTLIER SMOKES, CLEANER LUNGS?

Why the payoff from higher tobacco prices may be elusive

When President Clinton laid out his policy on tobacco on Sept. 17, the centerpiece was a $1.50-per-pack increase in the price of cigarettes. Although Clinton didn't spell out the details, such a price hike would probably be spread out over several years and adjusted for inflation. But no matter how the mechanics of the concept are resolved, it is clear that his plan would sting smokers: the cost of a pack of smokes could easily climb by 80%, to a nation-wide average of about $3.50.

What is much less clear is whether a $1.50-per-pack price hike would achieve the President's top policy goal: cutting youth smoking in half by 2005. And that's not the only question surrounding the potential cigarette sticker shock. Would it create a massive black [illegible] That's what happened in Canada in the early 1990s after the country raised to[illegible] bacco taxes by more than 250%. In fac[illegible] bootlegging became such a problem tha[illegible] taxes were rolled back in 1994. [illegible]

What about the tobacco industry's profits? Will they be pummeled? [illegible] mous state and federal tax dollars are also at stake. Will overall cigarette levels decline? Although in many cases the answers can only be preliminary, close investigation reveals that a $1.50-per-pack price increase would affect [illegible] more than just smokers and tobacco companies. It would be one of the most important public-health initiatives in history, with far-reaching effects on everyone from taxpayers to retailers to law enforcement authorities.

The most critical issue surrounding the price hike is whether it would [illegible] consumption by teens. [illegible] cording to Frank Chaloupka, a University of Illinois associate professor and an expert on the economics of smoking, a 10% increase in the price of cigarettes leads to a 6.75% decrease in the number of teens who smoke. Because a $1.50 price hike would increase the average nationwide cost of a pack of smokes by close to 80%, his studies suggest that teen smoking should fall by well over the desired 50%.

BLACK MARKET. But, as Chaloupka points out, the size of the proposed cigarette price spike is unprecedented. His nationwide studies are based on the small price fluctuations that have occurred in the past. Those and other factors, then, skew the correlations to his studies; the rate of decrease in tee[illegible] smoking may slow down as the price hike climbs.

For one thing, a black market could develop that would supply youths with cheaper cigarettes, says Gary Black, a tobacco analyst with Sanford C. Bernstein & Co. Additionally, teens could trade down from Marlboro and Camel to discount brands (though Black and many health authorities note that younger smokers are particularly label-conscious). Retailers also may hold down prices to build store traffic, Black says.

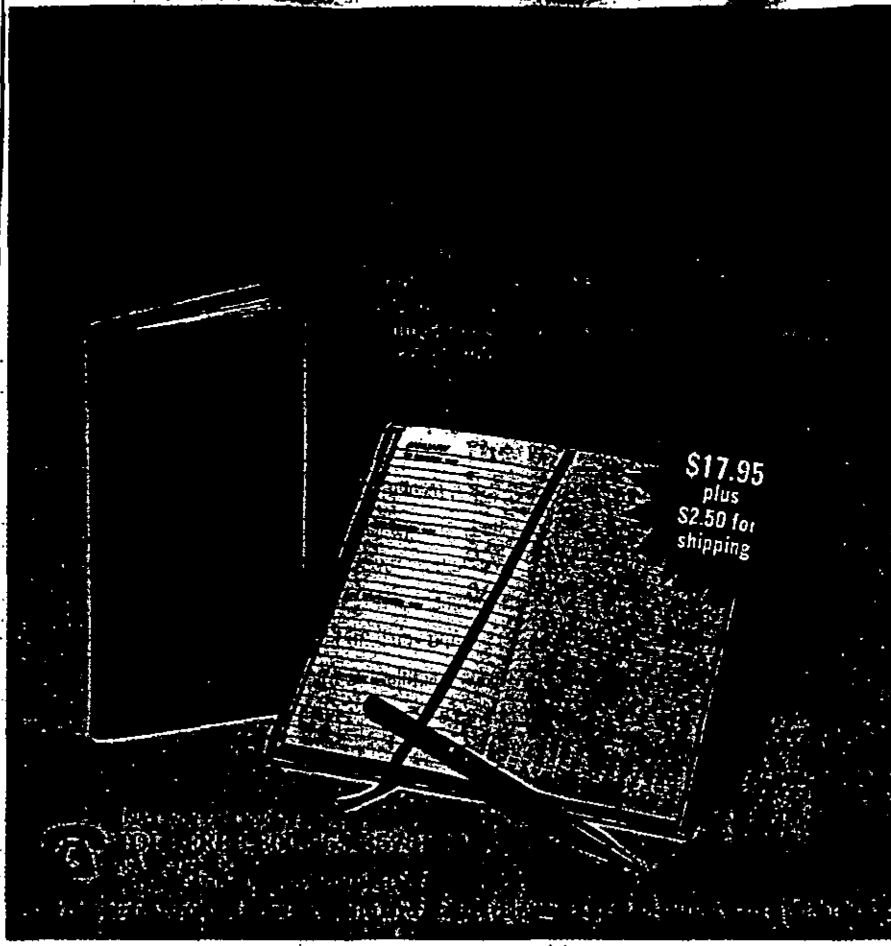
Many health advocates, meanwhile, say that while a $1.50 increase would have a large impact if it were imposed immediately, the impact will be diminished if it is phased in gradually. Bottom line: The hike would certainly take a big bite out of teen smoking—but don't bet on cutting it in half.

Another contentious issue is whether a black market in cigarettes will emerge in reaction to a price jump. Pointing to Canada's experience—as well as that of Michigan, which saw a dramatic increase in smuggling after it raised cigarette taxes—the industry and its defenders are convinced that Clinton's plan would lead to a burgeoning market in contraband tobacco. "A black market always comes in to fill the gap" between places with high cigarette prices and those with lower ones, says Gary Auxier, senior vice-president of the National Smokers Alliance in Alexandria, Va.

DIFFERENT SCENARIO. Law enforcement authorities worry that this might create a profitable new line of business for organized crime. In Michigan—where the cigarette excise tax jumped from 25¢ in 1994 to [illegible] in 1996—Middle Eastern gangs that also specialize in illegal gambling have entered the trade, says Detective Sergeant James Ward, supervisor of the state police's Tobacco Products Tax Team.

But health authorities say that neither Canada's nor Michigan's experiences shed much light on what would happen if the U.S. adopted a national $1.50 price hike. Unlike Canada, which saw an uncontrollable influx of cigarettes from the U.S., the U.S. wouldn't be adjacent to any enormous source of contraband tobacco, says David Sweanor, of the Non-Smokers' Rights Assn. in Ottawa.

For one thing, Canada's provinces would likely greet an American price hike with an almost immediate tax increase of their own, Sweanor says. And the Mexican border is much more heavily policed. Trucking in large quantities of tobacco would be an iffy economic proposition—especially if the U.S. raised



tobacco taxes, marked cigarette with easily visible tax stamps, and an eye on industry sales to no Mexico, Sweanor says. And while state smuggling would certainly st ist, the relative importance of the differences in state excise taxes be less important if a nationwide hike were enacted.

PROFIT LOSS. Of course, tobacco panies will feel the impact quickly. worst-case scenario would occur if gress insisted that the entire $1.50- pack increase apply immediately many health groups wish. If that h pens, Philip Morris Cos.' 1998 estima operating profits from domestic toba would drop from $4.7 billion to $2.7 lion, says Black. Estimated earnings share would probably drop from $ per share to $2.90. At RJR Nabisco estimated domestic tobacco reven would drop from $1.5 billion to ab $950 million, while estimated earni per share would fall from $3 to $2.

But an immediate price hike is likely—and to the extent that spread out over time, the earning will diminish. It is also likely that m of the cost increase will come in form of a penalty if youth-smoking duction targets are not met. The fas the industry hits the targets, the les the price hike—and the smaller th pact on profits. Given the new adver ing restrictions that Congress wi probably create, Black also esti that the industry's $6 billion in an marketing expenses could drop by

Finally, the original tobacco set ment deal gave companies a broad trust exemption. They may "act in cert" to achieve "the goals of agreement." If the provision remains a new deal, Federal Trade Commissi Chairman Robert Pitofsky warns t manufacturers may be able to increa profits by raising prices far above t level needed to pay for the settleme

Will government coffers start ov flowing from a cigarette tax hike? Un Congress decides how much of t $1.50-per-pack increase will come in t form of increased levies and how mu will be in the form of penalties, it impossible to predict how Clinton's pl would affect government treasuries. B tax increases, if they are imposed, wo necessarily guarantee more revenue. they actually push down smoking, go ernment receipts could actually decli But then again, maybe that's a pri the country is willing to pay.

By Mike France, with Peter Coy New York and Susan Garland Washington

FROM : Gary&FlorenceBlack PHONE NO. : 908 899 8494 Sep. 20 1997 08:18AM P2
SEP 19 '97 11:42 FR BERNSTEIN RESEARCH 212 756 4576 TO 913128561032 P.02/02

tobacco - settlement - industry performance

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TOBACCO

Clinton's Speech: What The Skeptics Are Missing. Outperform on MO, RN, UST.

Stock	Rtng	Price	YTD Perf.	Earnings 1996A	Earnings 1997E	Earnings 1998E	P/E 1997E	P/E 1998E	Rel P/E 1997E	Rel P/E 1998E	97-01E CGR %	EV / EBITA	Yield
MO	O	$41	+8	$2.56	$2.95	$3.15	13.9x	13.0x	66	67	14%	8.2	3.6%
RN	O	33	(4)	2.62	2.95	3.00	11.2	11.0	53	56	12	6.4	6.4
UST	O	31	(5)	2.42	2.45	2.67	12.7	11.6	61	60	9	6.9	5.7
SPX		947	+28	40.50	45.00	48.50	21.0	19.5	100	100	7	—	1.6

HIGHLIGHTS

1. We continue to put 80% odds that the June 20th settlement negotiated between the industry and attorneys general, with some of the changes offered by President Clinton, will be enacted as law by Congress next Spring. Stocks are likely to stagnate here until a favorable 4th Circuit ruling on FDA jurisdiction, which could produce a +5-10% pop.

2. We strongly disagree with the prevailing view in the press that the June 20th agreement is dead. Our Washington sources indicate it was politically necessary for the Administration to seed the idea in the media that there is a new deal: (a) to address the perception in Washington that the old deal was a bailout for the industry; (b) to overcome Congress' "not-invented here" syndrome; and (c) to get Dr. Kessler and Dr. Koop on board.

3. Concerns that Congress would pass a tobacco legislative deal with no liability protections for the industry seem misplaced: (a) without the industry's blessing, legislated advertising bans would likely not survive constitutional challenges; (b) the industry still has friends in the Republican leadership and in the thirteen tobacco growing states, which serve as an effective veto over an unsuitable deal; (c) adversarial relationship is not President Clinton's style.

4. We expect the industry to conclude that it can live with tougher penalties tied to youth smoking rates. Logic: If the industry does everything within its power to reduce youth smoking and fails, cigarette prices could be raised sharply as a *last resort* to achieve the youth smoking targets and avoid the stiff penalties – causing profits to soar. This fits with our view that the domestic tobacco industry be placed back into a harvest mode, as it was during the 1980's.

5. Our biggest concern with the AG settlement is the soft cap on individual awards. If individual damage awards exceed $5 billion, the excess is rolled over into the following year. We would prefer a hard cap since this would eliminate investor uncertainty that Congress might ultimately raise the caps if the unmet liability became too high.

6. In speaking with AG Mike Moore and plaintiff attorney Richard Scruggs yesterday, we believe there will be major changes in the public relations effort now that President Clinton has taken an equity interest in this deal: (a) Koop and Kessler will lobby for the deal; (b) Moore plans to start a "death clock" to remind Congress that each day legislation is not passed 3,000 more kids will begin smoking; and (c) industry executives such as Geoff Bible and Steve Goldstone will become more proactive in their efforts to sell Congress the benefits of the deal.

INVESTMENT CONCLUSION

We reiterate outperform ratings on MO, RN, UST. While we are frustrated that the market has for now sided with the newspaper reports that suggest the original tobacco settlement is dead, we believe the tide will turn with a favorable ruling by the 4th Circuit panel, rejecting FDA jurisdiction (end of October), and a possible delay in the Texas Medicaid case if the 5th Circuit intervenes on mandamus prior to the September 29 trial. Unfortunately, we expect any rally to be short-lived given the anticipated lull in the resolution of the settlement as Congress adjourns from November to mid-January. Our 6-12 month price targets remain MO $60, RN $44, and UST $40, although we expect stocks to be only modesty higher (on the heels of a favorable 4th Circuit ruling) by year end.

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mam

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September 17, 1997

TOBACCO

Clinton Pulls Everyone Under The Tent. Lookback Penalties Could Be Avoided By Raising Prices.

Stock	Rtng	Price	YTD Perf.	Earnings 1996A	Earnings 1997E	Earnings 1998E	P/E 1997E	P/E 1998E	Rel P/E 1997E	Rel P/E 1998E	97-01E CGR %	EV / EBITA	Yield
MO	O	$42	+13	$2.56	$2.95	$3.15	14.3x	13.4x	68	68	14%	8.5	3.8%
RN	O	33	(2)	2.62	2.95	3.00	11.2	11.0	53	56	12	6.3	6.2
UST	O	31	(4)	2.42	2.45	2.67	12.7	11.6	61	60	9	8.0	5.2
SPX		946	+28	40.50	45.00	48.50	21.0	19.5	100	100	7	--	1.6

"The report of my death was an exaggeration." Mark Twain

HIGHLIGHTS

1. We view President Clinton's tobacco settlement speech as fairly bullish; it appears that Dr. Kessler, Congressman Waxman, and Minnesota AG Skip Humphrey are all now on board, which greatly enhances odds of this deal passing. President Clinton offered broad, general themes of what he seeks in legislation, and offered few specifics other than full authority by the FDA over nicotine, stiff penalties if youth smoking rates fail to drop, and full disclosure of documents.

2. We expect the industry to embrace the President's position, although RJR and BAT are thought to remain deeply troubled by the proposed steep lookback pricing that would kick in after ten years if other measures to reduce teen smoking fail. Still, we don't see anyone walking away, given the potential to temper penalty provisions when Congress begins its review in 1998.

3. Many investors have failed to see that the industry could simply jack up prices by $1/pack or more by itself to achieve youth lookback targets, and thereby avoid the penalties spelled out by President Clinton. This rather bizarre conclusion -- that the industry could dodge what works out to be an incremental $.88/pack in penalties simply by raising prices sufficiently to achieve youth smoking targets, and then pocketing the excess profits -- would cause MO and RN earnings to soar.

4. With no chance of a deal being enacted this year, and still reeling from the public relations disaster associated with repeal of the $50 billion excise tax credit, we expect the industry to step back from the settlement debate, and wait for the 4th Circuit to rule on FDA jurisdiction, and try to convince the 5th Circuit to intervene on mandamus in the Texas Medicaid case.

5. We believe the 4th Circuit will reverse Judge Osteen and rule that the FDA cannot assert jurisdiction over tobacco. This would dramatically alter settlement dynamics, since absent FDA jurisdiction or further excise tax increases by Congress, the Administration would have no choice but to embrace the settlement to have any chance of reducing youth smoking.

6. In Texas, the parties will on Thursday ask Judge Folsom for dismissal of remaining claims. We expect Folsom to deny the motion, and deny the industry's request to certify the ruling to the 5th Circuit. The industry will seek mandamus review by the 5th Circuit, which is rare pre-trial, but could be granted by this conservative and traditionally pro-tobacco court. We still see no settlement in Texas, to send the message that absent a national settlement, the other 48 states will get no money.

7. Our Washington sources indicate that a standalone $1.50 - $2.00/pack excise tax would be dead on arrival, given a) an already worsening contraband market (30% of Michigan sales, 20% of New York sales) diverted from low-tax to high-tax states; b) Congressman from 13 tobacco-growing states won't likely endorse a tax hike of this magnitude; and c) Republican leadership is now likely to get on board this deal with President Clinton having offered political cover in today's speech.

8. <u>Downside</u>: If the industry walks, we could see a backlash against the industry in the current highly-charged political environment. This could cause Congress to pass a standalone $1.50/pack excise tax hike without liability protections. This would reduce Philip Morris 1998E earnings from $3.15 to $2.90, RJR 1998E earnings from $3.00 to $2.35, and assuming a proportional snuff tax increase, UST 1998E earnings from $2.67 to $2.60. Odds of the industry walking are remote.

INVESTMENT CONCLUSIONS

We reiterate outperform ratings on Philip Morris, RJR, and UST. With Dr. Kessler, Dr. Koop, and Congressman Waxman all now on board the settlement, combined with our view that the lookback penalties are essentially a non-issue, with the industry able to avoid the excess penalties simply by taking excess pricing, Clinton's speech today sharply increases odds that this deal will get done next year. As we have said before, we cannot see anti-tobacco members of Congress and the Administration walking away from $400 billion that can be used for national health care, and industry concessions that include ceding jurisdiction to the FDA; elimination of Marlboro Man and other brand equities; bans on billboards, vending machines, sponsorships, in-store advertising, and self-service displays; and agreements to pay billions for smoking cessation, tobacco education and awareness, and cancer research. We expect stocks to rally in the days following the speech, given the high likelihood that the Republican leadership finds political cover to now endorse this deal, and given strong odds of favorable resolution on the FDA jurisdiction question in the 4th Circuit and Texas Medicaid case in the 5th Circuit. The industry has also asked the Minnesota district court to dismiss the state of Minnesota's direct action against the industry on precedent established by the Minnesota Supreme Court in dismissing Blue Cross and Blue Shield's claims against the industry. If the judge denies this motion, as we expect, the industry can take the issue to the Minnesota Supreme Court. Our one worry is that Administration betrays the partnership with the industry that it staked out today, and instead embarks on a course to punish the industry, by either doubling the payments, or rejects the deal's liability protections for the industry. This would cause the deal to effectively die, with downsides at Philip Morris of $40, RJR Nabisco $29, and UST, which doesn't really move with odds of a deal, $30.

ADDITIONAL DETAILS

1. Deal moves forward, as everyone gets under the tent. President Clinton avoided specifics in his speech today and offered a general embrace of the principles found in the tobacco settlement negotiated between the attorneys general and the tobacco industry. Clinton made clear, however, that the June settlement needs fundamental changes in areas that we have talked of at length -- FDA control over nicotine, stiffer penalties (including non-tax deductibility of penalties) if youth smoking rates fail to drop, and the release of all documents. What was not in the Clinton speech was a definitive price tag, or a requirement that *payments* -- as opposed to *penalties* -- be sharply increased from the terms found in the June 20 settlement ($368 billion payments per year, plus a potential $42 billion in lookback penalties if youth smoking objectives are not achieved). By outlining general principles, but not specific provisions of a deal, Clinton followed a political strategy that has worked well for him in the past. After legislation has been enacted, Clinton can claim he got what he wanted, and take credit for any shape deal. Clinton also likely will avoid the criticism heaped on the industry and the attorneys general when it "dumped" the deal on Congress' lap (Majority Whip Don Nickles) in telling Congress how to do its job. Clinton seems too savvy a political operator to turn the industry into an adversary at this stage in the legislative process. Clinton will likely keep the settlement on slow simmer through the end of the year, and then bring it up to a boil with detailed recommendations -- ideally hammered out between the industry, Administration, and key members of Congress -- by early next year, with the goal of getting comprehensive legislation out by March or April in time for election campaigning.

2. Major difference between increased penalties and increased payments. Our sources indicate that settlement talks between the industry and the Administration broke down last week after the Administration insisted that caps on the lookback provision be lifted, that fines be non-tax deductible, and that the 75% abatement provision be tightened. According to one source in the industry, this would have effectively raised the settlement price tag from $17 billion per year ($15 billion base payment, plus $2 billion per year in maximum lookback penalties, in real dollars) to $23 billion per year ($15 billion base payment, plus the equivalent of $8 billion in lookback penalties *that only kick in if youth smoking targets are not met).* Put differently, the June 20 settlement translates to an effective price hike of $.70/pack in 1997 dollars -- $.62 in base payments, plus $.08/pack in lookback penalties which don't kick in for five or even ten years. Clinton's speech asked for significantly higher penalties if youth smoking rates don't fall. This indicates to us that Clinton likely did not have problems with the base payments, but wants to make sure the industry has strong incentives -- $.88/pack, or $21 billion per year in new penalties — that automatically kick in if youth smoking rates fail to decline after the industry implements marketing and retail access initiatives. The deal turned down by the industry last week would have effectively raised the cost of settlement from $17 billion per year shown above ($.62/pack plus $.08/pack lookback pricing), to $23 billion per year, including $8 billion in lookback penalties ($.62/pack base payment, plus $.33/pack in lookback penalties).

Comparing Settlements	Attorney General Settlement		Implied Clinton Proposal	
Year 10				
Base payments	$15.0	$.62	$15.0	$.62
Lookback penalties	$2.0	.08	$21.0	.88
Total payments	$17.0	$.70	$36.0	$1.50
Memo: Packs sold (bill.)	24.0		24.0	

3. **Industry can take excess pricing to depress youth smoking -- and avoid the lookback fines.** *What is quite bizarre about* the $1.50/pack pricing debate that has depressed valuations over the past few days is that the industry can easily achieve the youth lookback provisions and avoid the gargantuan penalties by simply raising prices on its own by an amount sufficient to reduce teen smoking by 30% in year 5, by 50% in year 7, and 60% in year 10. Currently, 18% of 8th, 10th, and 12th graders smoke; to avoid any penalty, youth smoking would have to fall to 7.2% within 10 years. This lookback incentive, endorsed today by President Clinton, is tantamount to giving the industry license to raise prices by $.75/pack or more if it finds itself in a position where it can't get youth smoking rates down to the targeted levels via marketing and access controls. To avoid paying what would amount to a $21 billion, or $.88/pack fine, to the government, the industry could, as a last resort, simply jack up prices by an amount needed to depress consumption by the required amount, and in so doing, avoid the fines.

This is not so onerous as one might expect, and from a P&L standpoint, could be a godsend: Currently, the industry recruits 3,000 new smokers each day, which means that 1.1 million smokers enter the industry's customer base each year. The industry's current customer base numbers 50 million. About 1.6 million leave the industry's customer base each year, resulting in an intrinsic loss of 500,000 customers each year, for a net growth rate of -1%. If the industry succeeds in reducing the number of new smokers by 60% -- i.e., can avoid gaining 700,000 new smokers each year -- the intrinsic growth rate of the industry would deteriorate to a net outflow of 1.2 million smokers per year, doubling the industry's natural rate of decline to -2.4% (this would increase over time as the existing customer base shrinks, and as existing smokers quit in reaction to sharp increases in cigarette prices). A (1.5) point deterioration in domestic tobacco volume is worth about $(.02)/share to MO earnings, building cumulatively, and about $(.05)/share to RJR earnings, building cumulatively.

A second way to look at this is as follows: With an elasticity of demand of 0.4, a $1.50/pack price hike -- $.88 taken to depress youth consumption to avoid paying $21 billion in penalties -- would force prices up by 90% ($3.40 vs. $1.85), and could cause consumption to fall by 35% (we believe the actual consumption decline would be less, since smokers would trade down, buy cigarettes on the expanding contraband market, and seek out retailers willing to sell cigarettes at cost to build store traffic). A 35% drop in consumption -- this over 10 years -- would be worth approximately $1.6 in profits, or $.40/share to Philip Morris earnings, and roughly $500 million, or $.85/share to RJR earnings. But the profits from the $.88/pack in excess pricing for those 65% of smokers who remain could overwhelm the consumption hit: PM USA profits could jump some $6 billion (vs. $1.4 billion consumption hit); RJR profits could soar $3 billion (vs. $600 million consumption hit). The result would be net earnings gains of $1/share at Philip Morris, and $4/share at RJR.

we need to write penalties sufficient to prevent this

4. **Contraband market remains major uncertainty. Ask Michigan what happens when excise taxes triple.** When we ask wholesalers what is the single biggest reason youth smoking rates may not go down, even if all of these measures are implemented, they universally point to the explosion in contraband sales that they are already seeing, which most attribute to sharp increases in state excise taxes over the past few years (+8% compounded since 1994). We expect Congress to evaluate this issue carefully before embarking on any course of action, given what happened in Canada during the mid-1990s when cigarette prices doubled as excise taxes quadrupled (35% of market went contraband), and closer to home, what has happened in Michigan since 1994 as excise taxes have more than tripled (30% of market reported to be contraband sales).

	North Carolina			Michigan			
	Volume (MM pks)	Excise tax per pack	Price per pack	Volume (MM pks)	Excise tax per pack	Price per pack	Combined volumes
1993							
1994	763.7	$.05	$1.35	1,059.2	$.25	$1.63	1,822.9
1995	873.3	$.05	$1.42	786.2	$.75	$2.24	1,659.5
1996	924.5	$.05	$1.45	788.8	$.95	$2.29	1,713.3
% Change	+21%			-26%			-6%

Combined volumes were down only -2.9% over two years, when adjusted for gains in Kentucky (+9% in two years)

In our many discussions with Administration officials over the past few months, no one has ever asked us what happens to contraband sales if cigarette prices double? In Michigan, taxable removals have plummeted by 26% since 1994, as excise taxes increased from $.25/pack to $.95/pack (+$.70/pack). This has caused average prices in Michigan to increase from $1.63 to $2.29 (increase only $.66/pack), as retailers increasingly squeeze margins to attract price-sensitive smokers looking for the lowest possible price. In North Carolina, where excise taxes are just $.05/pack, and cigarettes cost $1.45/pack, taxable removals have increased by +21% since 1994 -- coincident with the decline in Michigan, and strongly suggesting that cigarettes are being purchased in North Carolina and then shipped to Michigan, where they are distributed via newsstands, local stores, and alternative outlets such as bars and clubs. With the combination of up to $1.50/pack in excess pricing, and new tougher retail access rules for youths, we would expect the national contraband market to jump from its current estimated 5% nationwide to 20-25% within 5 years. This, of course, could negate all of the efforts to reduce youth smoking brought about by the tobacco settlement, as teens increasingly buy their cigarettes outside traditional outlets.

'OBACCO INDUSTRY

.ttorney General Settlement Payments

	0	1	2	3	4	5	6	7	8	9	10	11	~	25	Total
torney general funds:															
State funds	4,000	1,600	1,800	2,000	2,600	2,600	3,200	3,200	3,200	3,200	3,200	3,200		3,200	78,600
Federal recovery = 60%	6,000	2,400	2,700	3,000	3,900	3,900	4,800	4,800	4,800	4,800	4,800	4,800		4,800	117,900
Total AG funds	10,000	4,000	4,500	5,000	6,500	6,500	8,000	8,000	8,000	8,000	8,000	8,000		8,000	196,500
lividual awards and settlements:															
Nominal amount (1/3 of base payments)	-	2,000	2,500	3,500	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000		4,000	96,000
Anticipated unused (earmarked for public health trust)	-	(2,000)	(2,200)	(2,800)	(3,000)	(3,000)	(2,500)	(2,500)	(2,500)	-	-	-		-	(20,500)
Net individual awards	-	-	300	700	1,000	1,000	1,500	1,500	1,500	4,000	4,000	4,000		4,000	75,500
bacco cessation	-	1,000	1,000	1,000	1,000	1,000	1,500	1,500	1,500	1,500	1,500	1,500		1,500	35,000
blic health funds (HHS):															
Public education campaign	-	500	500	500	500	500	500	500	500	500	500	500		500	12,500
HHS -- Reduction in tobacco usage	-	125	125	125	225	225	225	225	225	225	225	225		225	5,325
FDA -- Enforcement of Act	-	300	300	300	300	300	300	300	300	300	300	300		300	7,500
State and local control efforts (ASSIST)	-	75	75	100	125	125	125	125	125	125	125	125		125	3,000
Research for smoking cessation	-	-	100	100	100	100	100	100	100	100	100	100		100	2,400
Compensation for lost sponsorships	-	-	75	75	75	75	75	75	75	75	75	75		-	750
Undefined public health funds	-	-	25	100	175	175	175	175	175	175	175	175		250	5,025
Public health funds	-	1,000	1,200	1,300	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500		1,500	36,500
esident's Public Health Trust ($25 billion)	-	2,500	2,500	3,500	4,000	5,000	2,500	2,500	2,500	-	-	-		-	25,000
OTAL PAYMENTS	10,000	8,500	9,500	11,500	14,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000		15,000	368,500
emo: Maximum lookback penalties *	-	-	-	-	-	2,000	2,000	2,000	2,000	2,000	2,000	2,000		2,000	42,000
OTAL PAYMENTS AND PENALTIES	10,000	8,500	9,500	11,500	14,000	17,000	17,000	17,000	17,000	17,000	17,000	17,000		17,000	410,500
-- Per pack, in 1997 dollars	$ -	$ 0.35	$ 0.40	$ 0.48	$ 0.58	$ 0.72	$ 0.72	$ 0.72	$ 0.72	$ 0.72	$ 0.72	$ 0.72		$ 0.72	$ 0.70
emo: Industry cap (lookback fines fall outside cap)	10,000	9,000	10,125	12,375	15,000	16,000	16,000	16,000	16,000	16,000	16,000	16,000		16,000	392,500
lculation of cap:	-														
Total payments	10,000	8,500	9,500	11,500	14,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000		15,000	368,500
Less: 80% credit on individual awards	-	2,000	2,500	3,500	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000		4,000	96,000
Maximum liability before awards	10,000	6,500	7,000	8,000	10,000	11,000	11,000	11,000	11,000	11,000	11,000	11,000		11,000	272,500
Maximumum awards	-	2,500	3,125	4,375	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000		5,000	120,000
Total cap	10,000	9,000	10,125	12,375	15,000	16,000	16,000	16,000	16,000	16,000	16,000	16,000		16,000	392,500

Lookback penalty: Youth smoking prevalence, as measured by University of Michigan annual survey of 8th, 10th, and 12th graders) 30% reduction by Year 5, 50% by Year 7, 60% by year 10. Penalty - $80MM per pp, subject to $2.0 billion cap) tobacco settlement — industry performance

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September 29, 1997

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Tobacco Litigation

A Tobacco Settlement Makes Sense — Yet The Odds Remain Uncertain

- Wall Street appears to have decided that a tobacco settlement will occur in early 1998. In our opinion, a settlement will substantially further the goals of the anti-tobacco lobby. Yet is still subject to the substantial vagaries of Congress. In recent weeks, relative P/E valuations have deteriorated as the market has begun to appreciate that a legislated settlement is unlikely before early 1998.

- All rational argument points to the settlement being implemented, yet we think it may be imprudent for investors to ignore altogether the possibility of Congress derailing the proposal. Leadership in the House and Senate will be required for the current proposal to be both drafted into legislation and implemented by Congress. Strong stewardship of the bill remains uncertain.

- Through February 1998, equity valuations will likely remain volatile as news emerges on FDA jurisdiction from the Fourth Circuit, as well as the Texas and Minnesota cases. Further, there are not many predictable events likely to improve valuations in the short term. The 4th Circuit decision on FDA jurisdiction may possibly be one yet we think on balance, over the next few months there is the possibility of advantage and set-back for both sides.

- No enduring settlement valuation premium is probable before a bipartisan Congressional consensus has emerged and we think that this is unlikely to occur before the middle of 1Q98.

- Longer term, odds of a settlement are perhaps 2/3rds in favor. As a result we favor a continued overweight position in the tobaccos. Without a settlement, Philip Morris is the only tobacco stock able to deliver good capital appreciation. This is as a result of it enjoying both growth and defensive qualities.

- **There has been much erroneous speculation of cigarette prices over the next five years. If the current settlement was to be legislated in early 1998, we believe that by 2002 the average retail price would rise by 81% to $3.34 from the 1996 average price of $1.85. On the final page of this note we have provided a comprehensive breakdown of cigarette pricing through 2002. We hope that this will help to dispel some of the myths that have been perpetuated in the recent past over proposed pricing.**

We Continue To Believe That Congressional Implementation Of The Proposed Tobacco Settlement Is The Speediest Method Of Attaining The Goals Of The U.S. Health Lobby. It Is Still Possible However That Congress Might Derail The Settlement By Rejecting The Concessions Made By The Industry.

The debate over the proposed tobacco settlement now rests firmly in the hands of Congress and the Administration. Ultimately, President Clinton will have to bless any proposed new legislation - and it is likely that that will only occur after a consensus view has emerged (on a bipartisan basis) from Congress.

It appears that tobacco investors are being urged to buy the sector's equities on the basis that a settlement will certainly occur. Every rational argument leads the observer to reach that conclusion. We think however that while a settlement is likely, it is no more than a probability. It takes a substantial leap of faith to move from thinking that a settlement will be legislated to promoting equity investment on that basis alone. In short, we think Congress is likely to legislate an acceptable new regulatory regime - although predicting Congressional action is an unreliable science. Perhaps the odds of a settlement are about 2/3rds in favor to 1/3 against. For investors, some key questions remain: 1) the existence and possible timing of a settlement; 2) the valuation environment prior to a settlement, and 3) equity weightings dependent on one's level of conviction that a settlement will/will not occur. In our opinion, there will be much valuation volatility through Feb '98 with little potential for good news during this period. On balance a settlement remains likely and sector overweightings are therefore appropriate. If no settlement occurs, only Philip Morris may be able to provide good long-term capital appreciation as a result of its growth and defensive qualities.

Congress And The Anti-Tobacco Lobby Make Very Few Sacrifices By Legislating The Proposed Resolution.

The rationale behind the existing settlement is clearly beneficial to all parties. The legislative process is however neither logical nor certain. In an election year, the potential for making tobacco a political cause throws further uncertainty onto the settlement. By legislating the deal, Congress does not preclude itself from making the tobacco regulatory environment tougher in years to come. Both Federal government, as well as the individual states retain complete jurisdiction for the level of tobacco excise taxes that may be imposed in the future. The retail price of cigarettes remains the most important determinant of tobacco consumption patterns. Congress could elect to make virtually any area of the US tobacco operating environment more onerous. The FDA will be able to apply food and drug manufacturing standards to tobacco. At a single stroke the industry has made significant concessions to its 1st Amendment Constitutional rights. Tobacco marketing will be speedily removed from the outdoor landscape of America; advertising campaigns will be designed to reach adult consumers only; and the implementation of these changes will occur without industry challenge. Retail prices will rise fast; and well in excess of the guidelines enunciated by President Clinton. If the deal is legislated in early 1998, we believe that the average price of a pack of 20 cigarettes will rise by 81% or $1.49 to $3.34 in 2002 from $1.85 in 1996. Using an elasticity of 0.4, overall US volumes may fall by 21% from 484 billion cigarettes in 1996 to 382 billion cigarettes in 2002. Using an elasticity of 0.33, overall US volumes may fall by 18% from 484 billion cigarettes in 1996 to 398 billion cigarettes in 2002.

There has been much inaccurate speculation over pricing of cigarettes as a result of the settlement. It is important to realize that it is not only the settlement cost that will increase retail prices. Federal tax hikes are currently scheduled for 2000 and 2002. Wholesaler margins of approximately 7% are likely to remain intact and are applied to the manufacturers cost, the per pack settlement penalty, and the federal excise tax. State excise taxes are likely to continue to rise; and retail margins will continue to be applied to the entire cost base described above. Local sales taxes, calculated as a percentage of the retail price help to expand further the retail price. President Clinton referred to cigarettes needing to rise in price by "...up to $1.50 over the next decade..." The current plan achieves this goal in about five years. In essence, the President was reluctant to criticize the financial penalties of the settlement. His most important comment underlined the negotiators goals of cutting youth consumption.

So How Might Congress Alter The Proposed Resolution?

Tobacco prices might rise further than envisaged as farmers are compensated for lower US consumption of tobacco; ultimately this charge may be borne by the consumer. The timing aspects of the deal that allow for the first annual payment to be made at the end of the year following the year in which the deal is legislated will likely become twelve months after the deal is legislated. The look back penalties may become more onerous although we doubt that the total cost of the deal will rise substantially. The checks on FDA jurisdiction for tobacco will likely be abolished, although we believe that even with full jurisdiction, the FDA will be unlikely to find a method of cutting consumption more quickly than simply using retail price increases. The implementation of the settlement penalty on the retail price may shift from being administered by the industry and the A.G.'s to a Federal excise tax basis. Naturally, the individual negotiating states would prefer the sums raised to remain outside the control of Federal government. In our opinion the settlement amount may be most easily raised as a tax. Questions of competitive pricing would be avoided and the FTC's recent criticism would be largely silenced. Federal government would however have to create a special apparatus to ensure that it acted only as a tax collector on behalf of the individual states; it would enjoy no direct revenue despite acting as a collection agent. This concept is pure speculation yet might be worthy of consideration as it eases the implementation of the financial aspects of the settlement.

Tobacco Equity Valuations Through Early 1998.

We believe that no settlement premium will begin to emerge until a consensus view becomes apparent from the Administration and Congress. In the next few months the major tobacco valuation events include: 1)The Texas Medicaid case against the industry (9/29) and a possible successful appeal to the Fifth Circuit, 2)A decision from the 4th Circuit on FDA jurisdiction of tobacco and tobacco marketing (imminent;) 3)The slight possibility that the MN Court of Appeals reaffirms the MN Blue Cross decision thus removing the state of MN's right to bring an independent course of action against tobacco. In short, we would expect a mix of positive and negative legal decisions over the next few months. No individual decision has the potential to grow valuations substantially, until the key uncertain issue of a settlement has been resolved.

Investment Conclusion.

A settlement remains likely but not certain. The legislative debate is messy; there are misleading indicators and extraneous variables. The Administration itself has to consider the widely divergent views of Congress. Through Feb '98 investors will likely be best served by trading the sector on increasing volatility and taking a view on the likelihood of a settlement. We would continue to overweight the sector for the long term, yet recognize the uncertainty that will likely prevail over the short term. Philip Morris remains the only equity attractive both with and without a settlement and we reiterate our **1H (Buy, High Risk)** recommendation. With the settlement, the total returns of RJR Nabisco (**2H - Outperform, Medium Risk**) may exceed 40% if a Nabisco spin off was to occur. Without a settlement however, we think the industry would have to prevail in at least a few of the state A.G. cases before the company would feel comfortable spinning off Nabisco. UST's valuation is unlikely to benefit as much from a settlement as either MO or RN, the converse however is that its valuation does not tend to drop as far on negative litigation news. UST's growth outlook remains uncertain and we reiterate our **3M (Neutral, Medium Risk)** recommendation.

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U.S. Cigarette Prices and Tax Incidence
Assumes $368.5 billion Settlement Legislated 1Q98
(Consumption Declines Based on 0.4 Elasticity)

Year	1996A	1997E	1998E	1999E	2000E	2001E	2002E
Industry volumes (billions)	484.0	476.7	467.5	451.1	412.7	399.3	382.4
% change in consumption	0.0%	-1.5%	-1.9%	-3.5%	-8.5%	-3.2%	-4.2%
# of packs (billions)	24.2	23.8	23.4	22.6	20.6	20.0	19.1
% change total from 1996-2002							*-21%*
% change in teen consumption [1]		-6.5%	-3.4%	-6.1%	-14.9%	-5.7%	-7.4%
% change total from 1996-2002							*-37%*
Discount segment of market [2]	28.6%	27.5%	30.3%	31.1%	33.3%	34.3%	35.4%
Discount volumes (billions)	138.3	131.1	141.7	140.3	137.4	137.0	135.4
% change in discount volumes	-	-5.2%	8.0%	-1.0%	-2.0%	-0.3%	-1.2%
Premium segment of market [3]	71.4%	72.5%	69.7%	68.9%	66.7%	65.7%	64.6%
Premium volumes (billions)	345.7	345.6	325.9	310.8	275.3	262.4	247.0
% change in premium volumes	-	0.0%	-5.7%	-4.6%	-11.4%	-4.7%	-5.9%
Original Settlement ($ billions)	0.00	0.00	0.00	8.76	10.1	12.6	15.8
Act. Settlement Amount ($ billions) [4]	0.00	1.67	3.00	5.00	8.6	10.4	12.4
Settlement cost (per pack)	$0.00	$0.07	$0.13	$0.21	$0.42	$0.52	$0.65
Per Pack Breakdown of Blended Average Retail Price							
Manufacturers' take [5]	$0.86	$0.91	$0.90	$0.94	$0.97	$1.01	$1.04
Manufacturers' take change [6]	-	6%	-1%	4%	3%	4%	3%
Federal tax [7]	$0.24	$0.24	$0.24	$0.24	$0.34	$0.34	$0.39
Settlement cost [8]	$0.00	$0.07	$0.13	$0.21	$0.42	$0.52	$0.65
Wholesalers' markup [9]	$0.08	$0.09	$0.09	$0.10	$0.12	$0.13	$0.14
State & local excise tax [10]	$0.32	$0.33	$0.36	$0.38	$0.42	$0.45	$0.49
Retailers' markup [11]	$0.27	$0.29	$0.31	$0.34	$0.41	$0.44	$0.49
Sales tax [12]	$0.09	$0.09	$0.10	$0.10	$0.13	$0.14	$0.15
Average Retail Price	**$1.85**	**$2.02**	**$2.12**	**$2.31**	**$2.80**	**$3.02**	**$3.34**
% change in retail price	-	9%	5%	9%	21%	8%	11%
% change retail price from 1996-2002							*81%*
Total Tax [13]	$0.65	$0.73	$0.82	$0.94	$1.30	$1.44	$1.68
Tax Incidence	**34.9%**	**36.1%**	**38.7%**	**40.6%**	**46.4%**	**47.8%**	**50.2%**

Footnotes:

1 Teen consumption decline is based on -.7 times % change in price.
2 Discount cigarette prices including excise taxes are $50.45 per thousand in 1997.
3 Premium cigarette prices including excise taxes are $61.95 per thousand in 1997.
4 Assumes minimum 3% inflation is applied to proposed annual payments but gives credit for volume declines among adult consumers.
5 Manufacturers' take excluding federal taxes.
6 Manufacturers' take decrease in 1998 is due to downtrading.
7 Assumes federal tax increase of $0.10 per pack in 2000 and $0.05 per pack in 2002.
8 Assumes $0.07 manufacturers' price increase in 9/97 is applied to settlement costs of FL & MS.
9 Wholesalers' markup is estimated to be approximately 7%.
10 Assumes state & local taxes increase by 8% per year.
11 Retailers' markup is estimated to be approximately 18%.
12 Average sales tax rate equals 4.7%.
13 Total taxes includes settlement costs/penalties as a form of tax.

Tobacco - industry performance   jmm

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TOBACCO

Political Chess Game Continues. Industry Likely To Back Off Until 4th Circuit Rules. Outperforms.

Stock	Rtng	Price	YTD Perf.	Earnings 1996A	Earnings 1997E	Earnings 1998E	P/E 1997E	P/E 1998E	Rel P/E 1997E	Rel P/E 1998E	97-01E CGR %	EV / EBITA	Yield
MO	O	$43	+13	$2.56	$2.95	$3.15	14.4x	13.5x	70	70	14%	8.7	3.8%
RN	O	34	+0	2.62	2.95	3.00	11.5	11.4	56	60	12	6.5	6.0
UST	O	31	(3)	2.42	2.45	2.67	12.7	11.6	62	61	9	8.1	5.2
SPX		924	+25	40.50	45.00	48.50	20.5	19.0	100	100	7	–	1.7

"Today, the proposed tobacco settlement is all but dead." John Broder and Barry Meier, New York Times

HIGHLIGHTS

1. We believe Clinton's embrace of the settlement will be favorable, but not specific. With no chance of a deal until next year, and little incentive for the industry to bend now, given the likelihood they will be hit up again for money when Congress reviews this deal next year, we expect tobacco stocks to languish until the 4th Circuit rules on FDA jurisdiction (Oct.-Nov.).

2. Clinton's demands will likely be in line with expectations: FDA must get unconditional control of nicotine, lookback penalties must be strengthened, industry must release all documents, and the price tag must be higher. Clinton's decision to talk about the deal only in general terms came after the industry rejected the Administration's latest lookback demands.

3. Rather than bargain from weakness, the industry will likely back off the deal until the 4th Circuit delivers what should be a favorable opinion, and figure out how to better sell this deal to Congress. We believe the industry has lost badly in the PR war to date, due largely to its own missteps – the $50 billion excise tax credit; arguments that the industry can't afford to pay more; and the reliance on hired guns to sell the deal when personal appearances by executives would have worked better.

4. With Clinton set to pass this deal off to Congress, where it will sit until the new year, we doubt the industry will settle with Texas. We expect Judge Folsom to refuse to certify his ruling denying dismissal to the 5th Circuit, and the 5th Circuit is unlikely to take the case on mandamus. We expect Folsom to bifurcate the trial, and try industry conduct first (begins 9/29).

5. The 4th Circuit's pending decision on FDA jurisdiction remains the key event that will drive settlement dynamics and hence valuations near-term. We now believe the three-justice panel will rule in all-or-nothing fashion, in contrast to the split decision (FDA got jurisdiction, but not over advertising) by Judge Osteen. We put odds at 60/40 in favor of the industry.

6. We continue to view this deal as a phased-in $.62/pack excise tax hike, with the industry agreeing to FDA regulation in return for sweeping liability protections. By the time this deal gets to Congress, we expect the price tag to have moved to the $420 billion range (payments in year 15-25 increased to $20 billion, or $.80/pack). We expect the industry to cede the unwinnable fight on lookback caps, and instead try to actually meet the youth prevalence targets, with different definitions.

7. Risks: We put odds at only 20% that Clinton makes terms so onerous that the industry walks permanently. This could cause a backlash against the industry, with Congress raising taxes, but litigation risks remaining. $1.50/pack price hike in Year 1 would cause our MO 1998E to fall to $2.95 (from $3.15) and RJR to $2.35 (from $3.00). Downside: MO $40; RN $29.

8. Key events:
   - Sept. 17: Clinton embraces deal, but declines to give specifics.
   - Sept. 29: TX Medicaid trial begins. Phase I - industry conduct (8 weeks). Industry likely to ask 5th Circuit for review.
   - End-of-September: Iowa legislators to convene special one-day session to try to pass Medicaid legislation like Florida's..
   - Mid-October: Broin Phase I trial goes to jury. No verdicts; jury decides whether industry was aware of dangers of ETS
   - End-of-October: 4th Circuit ruling on FDA jurisdiction, and FDA's ability to regulate advertising.
   - January 18: Minnesota Medicaid trial begins, assuming courts decline to dismiss state's direct actions.
   - Feb./Mar. 1998: Hearings and passage of tobacco settlement by Congress. November elections create May deadline.

INVESTMENT CONCLUSIONS

We reiterate our outperform ratings on MO, RN, and UST. With essentially no chance that this deal will pass this year, settlement uncertainty could bog down the group for another two months, or at least until the 4th Circuit ruling on FDA jurisdiction comes down. We expect the 4th Circuit ruling to give the group a major spike (5%-10%) if favorable, as investors realize that the Administration and anti-tobacco Congressmen will have to embrace the deal to get FDA control over nicotine and advertising. Both Texas and Minnesota now seem destined to go to trial before the deal is enacted, which, along with the Broin Phase I verdict and the 4th Circuit ruling, are the four drivers of valuations until Congress picks this deal up in January.

We continue to attach odds of 80% to Congress enacting the deal as negotiated, with modifications that we have outlined, by February or March of next year . We would ride out the current anti-settlement posturing that has swept through Washington, which is typical of all deals as they near critical junctures. Next year is an election year (full House, and 1/3 Senate); the closer one gets to election without a deal, the more pressure builds to exact punishment on the industry for political gain. In the end, we cannot see the Administration, health officials, or anti-tobacco members in Congress allowing this deal to just slip away, because the alternative is to wait for Congress to raise taxes by at least $.62/pack ($15 billion per year), and pass legislation that allows the FDA to regulate the industry -- which the Republican Congress seems loathe to do. Our price targets are MO $60 (market multiple), RN $44 (Nabisco x .65 = $27; Tobacco $2.90 cash earnings and $1.65 dividend worth $17), and UST $40 (80% relative). Near-term, we expect UST to perform the best, given the likely turnaround in volumes behind Copenhagen's new Long Cut and the Red Seal discount product, and little sensitivity to the national settlement.

ADDITIONAL DETAILS

1. Clinton's tepid endorsement: Ruse designed to get the industry to pay more? President Clinton's decision to offer a general endorsement of the settlement, with few if any specifics, is likely designed to keep the deal alive until next year, and force the industry to make additional concessions -- specifically on penalties associated with missing targets for youth smoking prevalence. Rather than pay up now, and then pay again when Congress picks up this deal after the new year, we expect the industry to simply back away from the deal for the time being, and wait for a favorable 4th Circuit ruling denying the FDA's efforts to assert jurisdiction over tobacco. Clinton's endorsement is expected to come Wednesday.

   In the end -- next year, when Congress starts deliberating this deal -- we expect the industry to give in on issues of more money (we expect final deal to be in the neighborhood of $420 billion, with years 15-25 picking up the additional payments), and tougher lookback penalties. With Clinton's staff unwilling to budge on their requirement that lookback provisions be strengthened -- deal on the table was to lift the caps, remove the abatement, and/or make the penalties non-tax deductible -- the industry may be inclined to shift gears, and simply accept the lookback penalties, but try to structure the measurement of youth smoking prevalence on a state-by-state basis. With caps lifted, penalties could amount to $4.8 billion per year (vs. $2.0 billion now), which would add about $50 billion to the cost of the deal. We calculate that each percentage reduction in new smokers is worth less than $30 million per percentage point, whereas the lookback penalties in the deal were incorrectly calculated at $80 million per percentage point, but for political reasons, cannot be reduced. The economics of the penalties suggests that the industry may cave in to higher lookback penalties, and instead try to meet the lookback objectives on a state by state basis, rather than continue to assail their logic. Evidence in California and Arizona suggests that a combination of price hikes, tougher access rules, and an aggressive anti-smoking media campaign, can cut youth smoking rates.

2. Will industry learn from its mistakes? Lawyers and politicians on both side of the settlement issue agree on one thing -- the industry is losing badly in the public relations war associated with this chess game.. We believe much of this reflects the industry's decision to take a low profile while this deal was being introduced to Washington following the historic June 20 agreement. This, however, gave the appearance that the tobacco executives were hiding, while hired guns such as Verner Lipfert and Mississippi Attorney General Mike Moore sold the deal to the Administration and Congress. Ironically, the highlight of the industry's public relations campaign over the last three months were the depositions in the Florida Medicaid trial by Philip Morris' Chairman Geoffrey Bible and RJR's Chairman Steven Goldstone, who went further than any other tobacco executives in suggesting there is a connection between smoking and lung cancer. In the hearings next year, we expect industry executives to become far more visible in selling the benefits of this deal.

   Obviously, the $50 billion excise tax credit was also a public relations disaster, since it served as a lightning rod for those dead set against this deal, and those who sought to gain politically by portraying the move as more evidence that the industry could not be trusted. Related to this were tobacco lawyers' statements before Congress that the industry simply couldn't afford to pay more, which also seemed to smack of deceit, given others' testimony that the equivalent of a $.62/pack tax hike would certainly not bankrupt the industry. We believe the industry will try to overcome efforts to raise the price tag of the deal in Congress by pointing out the significant contraband markets that have emerged when prices are increased sharply in other markets, which could, of course, negate all efforts to keep cigarettes out of the hands of children.

Tobacco Industry
Sensitivity: Impact of $1.50 Excise Tax Hike

Valuation - 1998E Proforma	Philip Morris	RJR Nabisco	Total Industry
Earnings per share	$3.45	$3.40	
Adjustments for consumption effect, interest payments	($0.50)	($1.05)	
Proforma earnings per share	$2.95	$2.35	
1998E-01E CGR %	15%	12%	
Absolute multiple	18.4	16.7	
Relative multiple	100%	90%	
Target Valuation	$55	$38	
% change vs. current value	28%	20%	
Settlement Impact - Detail:			
Total volume (billions of units)	233	114	473
Net sales ($ billions)	10,344	4,635	20,409
Total operating profits ($ millions)	4,671	1,482	7,935
Volume in packs (millions)	11,627	5,698	23,637
Net realization per pack	$0.89	$0.81	$0.86
Costs and expenses per pack	0.49	0.55	0.53
$ operating profit per pack	$0.40	$0.26	$0.34
Variable contribution per pack	$0.68	$0.54	$0.59
Marketing spending ($ millions)	3,023	1,829	6,621
Marketing spending per pack	$0.26	$0.32	$0.28
Settlement "pricing" to net $30 billion (incorporating consumption impact):			
Volume in packs (billions)	11,627	5,698	23,637
Price increase per thousand ($1.50/pack)	$1.50	$1.50	$1.50
Pricing contribution to settlement fund ($ millions)	$17,493	$8,573	$35,800
Consumption impact due to higher pricing:			
Volume in packs (from above)	11,626.8	5,697.7	23,637.0
Incremental drop in consumption	-33.4%	-33.4%	-33.4%
Loss in volume (millions of packs) [1]	(3,887)	(1,905)	(7,903)
Operating profit per pack	$0.40	$0.26	$0.34
Loss in operating profits	(1,562)	(496)	(2,653)
Interest expense on share of upfront payment:			
New debt to cover upfront payments	6,000	660	10,000
Interest expense on debt	7.0%	8.0%	6.5%
Profit impact	(420)	(53)	(650)
Total loss in operating profits	(1,982)	(548)	(3,303)
Marginal tax rate complement (1-tax rate)	0.62	0.62	0.62
Loss in net income	(1,229)	(340)	(2,048)
EPS impact - settlement *	$(0.40)	$(0.95)	
EPS impact - interest expense	(0.10)	(0.10)	
Total EPS adjustments	$(0.50)	$(1.05)	
Total earnings reduction	-15%	-31%	

Base Financial Coverage:	MO	RN
Domestic profits	4,671	1,482
International profits	5,489	901
Corporate expense	(383)	(65)
Total tobacco profits	9,777	2,318
Interest expense / preferred dividends	1,557	707
Fixed charge coverage	6.3	3.3
Revised Financial Coverage:		
Domestic profits	3,109	987
International profits	5,489	901
Corporate expense	(383)	(65)
Total tobacco profits	8,215	1,823
Interest expense / preferred dividends	1,977	760
Fixed charge coverage	4.2	2.4

Tobacco Industry
Estimated Value Of Lookback Provision

Background

- Approximately 3,000 new people begin smoking each day; most are presumably between the ages of 12-17.
- What is the cost to the industry of each percentage point reduction in these new smokers?

Assumptions:		
Number of new smokers per day	3,000	
x 365 days per year	365	
Number of new smokers per year	1,095,000	
Every 1pp loss in new smokers per year	10,950	Key Question: What is the value of these 10,950 smokers "lost" as customers ?
Value of a new smoker:		
Average packs smoked per year - per smoker	468	23.5 billion packs / 50 million smokers
Average profit per pack (full cost)	$0.33	Use full cost, since over time, will adjust SG&A if lose these smokers
Profit per year - per smoker	$154	Reality check: $7.7 billion profits / 50 million smokers = $154 / smoker
Value of a new smoker over the course of lifetime (6% cap rate = 13% pretax cost of capital, 7% growth)	$2,574	This is probably too high, since even if industry doesn't acquire as a customer as a kid, that kid might start smoking after reaches 18 yrs.
Value of an average smoker (reality check):		
Packs sold per year - total industry (billion)	23.5	
Average profit per pack (full cost)	$0.33	
Profit per year - total industry (billion)	$7.7	
Value of domestic tobacco industry (billion) (11.7% cap rate = 8-9x multiple)	$65.5	Avg. food company EV/EBITA = 11x (9% cap rate) Assume tobacco with no litigation risk would trade at 8-9x EBITA = 11-12% cap r
Number of smokers (millions)	49.8	
Value of an average smoker (avg. smoker is 38 years old)	$1,316	This makes sense -- 63 year old worth zero; 13-year old worth $2,574
"Lookback provision" math:		
A 1pp reduction in new smokers per year	10,950	New smokers lost each year -- presumably forever
Value of each new smoker (assuming lose for entire life)	$2,574	
Value of every 1pp reduction in new smokers per year	$28.2 MM	This is what industry would presumably pay to keep each 1pp of new smokers AG settlement: $80MM per percentage point, subject to a max of $2 bln per year (At max of $2 billion, 60% reduction worth $33.3 million per percentage point)
Value of 30% reduction (5 years)	846 MM	
Value of 50% reduction (7 years)	1,409 MM	
Value of 60% reduction (10 years)	$1,691 MM	Not the $4 billion estimate that some are posturing

Source: Sanford C. Bernstein estimates

SANFORD C. BERNSTEIN
Settle xls/Lookback/9/15/97

TOBACCO INDUSTRY
Settlement Allocation

	0	1	2	3	4	5	6	7	8	9	10	11	~	25	Total
ttorney general funds:															
State funds	4,000	1,600	1,800	2,000	2,600	2,600	3,200	3,200	3,200	3,200	3,200	3,200		3,200	78,600
Federal recovery = 60%	6,000	2,400	2,700	3,000	3,900	3,900	4,800	4,800	4,800	4,800	4,800	4,800		4,800	117,900
Total AG funds	10,000	4,000	4,500	5,000	6,500	6,500	8,000	8,000	8,000	8,000	8,000	8,000		8,000	196,500
ndividual awards and settlements:															
Nominal amount (1/3 of base payments)	-	2,000	2,500	3,500	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000		4,000	96,000
Anticipated unused (earmarked for public health trust)	-	(2,000)	(2,200)	(2,800)	(3,000)	(3,000)	(2,500)	(2,500)	(2,500)	-	-	-		-	(20,500)
Net individual awards	-	-	300	700	1,000	1,000	1,500	1,500	1,500	4,000	4,000	4,000		4,000	75,500
obacco cessation	-	1,000	1,000	1,000	1,000	1,000	1,500	1,500	1,500	1,500	1,500	1,500		1,500	35,000
ublic health funds (HHS):															
Public education campaign	-	500	500	500	500	500	500	500	500	500	500	500		500	12,500
HHS -- Reduction in tobacco usage	-	125	125	125	225	225	225	225	225	225	225	225		225	5,325
FDA -- Enforcement of Act	-	300	300	300	300	300	300	300	300	300	300	300		300	7,500
State and local control efforts (ASSIST)	-	75	75	100	125	125	125	125	125	125	125	125		125	3,000
Research for smoking cessation	-	-	100	100	100	100	100	100	100	100	100	100		100	2,400
Compensation for lost sponsorships	-	-	75	75	75	75	75	75	75	75	75	75		-	750
Undefined public health funds	-	-	25	100	175	175	175	175	175	175	175	175		250	5,025
Public health funds	-	1,000	1,200	1,300	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500		1,500	36,500
President's Public Health Trust ($25 billion)	-	2,500	2,500	3,500	4,000	5,000	2,500	2,500	2,500	-	-	-		-	25,000
TOTAL PAYMENTS	**10,000**	**8,500**	**9,500**	**11,500**	**14,000**	**15,000**	**15,000**	**15,000**	**15,000**	**15,000**	**15,000**	**15,000**		**15,000**	**368,500**
Industry cap	10,000	9,000	10,125	12,375	15,000	16,000	16,000	16,000	16,000	16,000	16,000	16,000		16,000	**392,500**
<u>Calculation of cap:</u>															
Total payments	10,000	8,500	9,500	11,500	14,000	15,000	15,000	15,000	15,000	15,000	15,000	15,000		15,000	368,500
Less: 80% credit on individual awards	-	2,000	2,500	3,500	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000		4,000	96,000
Maximum liability before awards	10,000	6,500	7,000	8,000	10,000	11,000	11,000	11,000	11,000	11,000	11,000	11,000		11,000	272,500
Maximumum awards	-	2,500	3,125	4,375	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000		5,000	120,000
Total cap	10,000	9,000	10,125	12,375	15,000	16,000	16,000	16,000	16,000	16,000	16,000	16,000		16,000	392,500

(from Gruber)

Tobacco - settle - Ind. performance

September 18, 1997

Would the Settlement Raise Cigarette Prices by $1.50?

Media reports indicate that Tobacco industry officials "contend [the settlement] would prompt the price to jump by almost $1.50 when inflation and wholesalers' costs are added" [*Washington Post*, Sept. 18] rather than the $0.62 increase that Treasury and other analysts have identified.

Response: The industry's claim overstates the likely price change for several reasons, including the effects of inflation and an overstatement of the likely markup at the wholesale and retail levels. Because of the pricing characteristics of the cigarette industry, a price increase of the higher amount would more likely result from *manufacturing firms'* efforts to increase profits not wholesalers or retailers. Most private analysts do not appear to expect a significant additional price markup beyond the costs of the settlement.

1. Inflation vs. Real Prices: The $0.62 increase attributable to the settlement is a real price expressed in today's dollars. Inflation would only raise that amount to about $0.83 in ten years.

> The numbers used to describe the annual payments and price increases of the settlement are typically expressed in real, inflation-adjusted terms. For example, the $368.5 billion figure does not account for inflation, rather it is expressed in terms of today's dollars. Similarly, the President's referral to an increase in cigarette prices of $1.50 is in terms of today's dollars (including the effect of inflation would raise it by 34% to about $2.00 a pack in ten years).

2. The Price Markup from Manufacturers to Wholesalers and Retailers: There is little evidence to support the argument that wholesalers or retailers would be able to increase their profits simply because they face a higher cost from manufacturers. An additional markup of ***80%*** at the wholesale or retail level -- as would be required to meet the industry claim -- clearly can't be defended.

> The industry argument would require a significant lack of competition at the wholesale and retail level in cigarette distribution. The evidence does not support such a view. *The only real lack of competition occurs at the manufacturing level (as a result of the small number of firms) giving them the ability to raise prices and generate greater profits.*

> The experience of earlier excise tax increases indicates that there has been only a small markup, if any, relative to the tax increase, and analysts concur that any markup that did occur went to higher manufacturer profits.

3. Most Private Analysts' Estimates Are Much Closer to $0.62 than to "$1.50" Reports indicate that most private (Wall Street) analysts expect little or no markup beyond the cost of passing through the settlement's payments. The bulk of the estimates are in the range of about 0 to 5% for the additional markup; the highest of which we are aware is about 30% -- about one-third the size apparently claimed by the industry.

Tobacco - settlement - antitrust
and
Tobacco - settlement - industry ~~analysis~~ performance

CC study to EK / File under Tobacco - Antitrust

FTC news

Federal Trade Commission Washington, D.C. 20580 (202) 326-2180

[EK - see esp. pp. A1-A10.

FOR RELEASE: SEPTEMBER 22, 1997

SUBSTANTIAL PROFITS FOR TOBACCO COMPANIES COULD RESULT FROM TOBACCO SETTLEMENT, SAYS FTC STAFF

Value of Proposed Agreement Also Could Be Less Than $368.5 Billion

According to a Federal Trade Commission staff report to Congress, cigarette manufacturers could realize substantial profits by increasing the price of cigarettes significantly above the level needed to satisfy their payments under the proposed settlement between the tobacco industry and 40 state Attorneys General. Profit increases could rise substantially, in part because of an antitrust exemption, which is much broader than necessary to achieve the legitimate public health goals of the settlement, the report says. The public sector -- federal and state governments -- also will gain financially from the settlement proposal, but the payments made by the companies most likely will be considerably less than the $368.5 billion in the agreement, the staff suggested. The report, an analysis of the potential economic impact of the proposed tobacco settlement, was requested by the House of Representatives Task Force on Tobacco and Health.

FTC Chairman Robert Pitofsky emphasized that the report takes no position on whether the settlement agreement, if modified, would be in the public interest. "Rather the goal," he said, "is to explain how the proposed settlement might affect the tobacco industry and how prices could increase well beyond the amount of annual payments called for under the agreement resulting in substantial profits for the companies. The report raises the question of what ought to be done with any additional monies the settlement could generate."

The FTC staff report, titled "Competition and the Financial Impact of the Proposed

-more-

Tobacco Industry Settlement" provides an overview of the U.S. cigarette industry and analyzes the effects of the proposed tobacco settlement on competition, prices, profits and public sector revenues. It identifies several features of the industry's past history and current structure that suggest why the industry is susceptible to coordinated price rises, including the tendency for price increases to consistently outpace cost increases, the small number of significant firms in the market, and the historical insulation of the cigarette industry from entry by new firms. Because of these features and the industry's historical response to tax increases, cigarette companies almost surely would raise prices by at least the amount they would be required to pay the public sector under the terms of the settlement, the report observes. "Moreover," according to the report, "certain features of the proposed settlement, particularly the antitrust exemption, have the potential to reduce competition and enhance the ability of the cigarette companies to 'coordinate' price increases," thus producing even greater price increases and profits.

The report provides several examples of the profits that could be generated if the cigarette manufacturers, through more effective coordination, raise prices by more than necessary to simply "pass through" to consumers the amount of the annual payments. If prices increase by 125 percent of the payments to consumers, their profits could increase by $36 billion over the next 25 years. Assuming prices rise by 200 percent of the annual payments, profit levels could be $123 billion higher over the next 25 years.

Public sector revenues also would increase if more effective coordination produces higher cigarette prices. "In general," the report says, "the companies would keep about two-thirds of the financial benefits . . . leaving one-third for the public sector."

An antitrust exemption under the settlement would allow the cigarette companies to coordinate their activities in order to achieve the goals of the agreement. A much more limited exemption might be justified, according to the report, in order to permit the companies to cooperate in limiting advertising and marketing so as to achieve the public health goals of the agreement. The current language of the agreement, however, could allow the parties to eliminate competition in the pricing of cigarettes, the report suggests.

The report also points out that the public sector would gain from the settlement proposal principally through annual payments made by the tobacco companies but these "will most likely be considerably less than the $368.5 billion in 'face value' of the proposed settlement," because it fails to account for the likely decrease in smoking and in cigarette sales. The settlement would require a fixed $10 billion payment from the industry due at signing and annual payments that increase in value over the term of the agreement. The staff report spells out the payment structure: "Unlike the initial payment due at signing, these payments are not fixed in value, but instead vary according to the volume of cigarettes sold each year and industry profits." Tax revenues also vary with sales volume and profits. After taking into account an anticipated decrease in smoking, the staff suggests that the public sector would only realize approximately $207 billion, if the settlement did not cause prices to rise by more than the level needed to satisfy the required annual payments.

The report concludes that "passage of an unnecessary or overly broad immunity runs the risk of facilitating price increases greater than that required simply to pass through the per-unit cost of their [a]nnual [p]ayments."

The views expressed in the staff report are not necessarily those of the Commission or any individual Commissioner. The Commission's vote to release the staff report was 4-0.

Copies of the staff report are available from the FTC's World Wide Web site at *http://www.ftc.gov* and from the FTC's Public Reference Branch, Room 130, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580; 202-326-2222; TTY for the hearing impaired 202-326-2502. To find out the latest news as it is announced, call the FTC's NewsPhone at 202-326-2710.

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(FTC File No. P859912)
(tobrep)

Competition and the Financial Impact of the Proposed Tobacco Industry Settlement

Requested by the
Congressional Task Force
on Tobacco and Health.

Prepared by the
staff of the
Federal Trade Commission.

September 1997

This report has been prepared by staff members of the Bureaus of Economics, Competition, and Consumer Protection. The views expressed do not necessarily reflect those of the Commission or any individual Commissioner.

Competition and the Financial Impact of the Proposed Tobacco Industry Settlement

This report has been prepared by staff members of the Bureaus of Economics, Competition, and Consumer Protection. The views expressed do not necessarily reflect those of the Commission or any individual Commissioner.

The information contained in this report is taken from public sources. References to trial exhibits reflect information made public in the FTC v. B.A.T Industries p.l.c. 94 Civ 7849 (filed October 31, 1994, S.D.N.Y.)

Questions about this report should be directed to Jonathan B. Baker, Director of the Bureau of Economics, at (202) 326-2930.

Executive Summary

This report has been prepared by staff of the Federal Trade Commission in response to the August 1, 1997 request from Representatives Martin T. Meehan, Henry Waxman, and James Hansen on behalf of the members of the Congressional Task Force on Tobacco and Health for an analysis of the potential economic impact of the proposed settlement with the tobacco industry on cigarette prices, industry profits, and government revenues. The report represents the work of the Bureaus of Economics, Competition, and Consumer Protection. As a staff report, it does not necessarily reflect the views of the Commission or any individual Commissioner.

Expertise of the Commission

The staff of the Commission has extensive experience, collected over decades, examining the competitive structure of the tobacco industry as well as its advertising and marketing practices. Pursuant to the Federal Cigarette Labeling and Advertising Act, 15 U.S.C. § 1331, the Commission annually reports to Congress on sales volume and advertising expenditures by the major domestic cigarette manufacturers. The Commission has additional responsibilities under the Cigarette Labeling and Advertising Act, and has investigated and periodically challenged cigarette advertising under Section 5 of the FTC Act, 15 U.S.C. § 45, which prohibits unfair or deceptive acts or practices. In addition, the Commission has investigated competitive practices of the cigarette firms and challenged the 1994 merger between the American Tobacco Company and Brown & Williamson.

Summary

One primary goal of the settlement is to reduce overall use of tobacco products, and in particular to reduce youth smoking. That goal is intended to be achieved by advertising and marketing restrictions, by raising the price of cigarettes and by a provision imposing financial penalties on cigarette manufacturers if certain goals for youth smoking reduction are not met. The price increase is realized by requiring manufacturers to make annual industry payments that will, among other things, fund various federal and state programs relating to tobacco usage. The proposed settlement contemplates that these industry payments will be "passed through" to consumers, which will result in higher cigarette prices, and presumably in turn, a reduction in youth smoking.

From an antitrust and economic perspective, a proposal that Congress enact a statute enabling private firms to agree to raise prices to pay past liabilities should be viewed with caution. This report does not directly address the policy choice between traditional antitrust and economic concerns and other important public policy and public health concerns. Rather, it is limited to the question posed by the Task Force -- the potential *economic* impact of the settlement on the industry and the public sector. Cigarette prices will rise if the settlement is enacted. This report addresses how much prices will rise and who will benefit from the anticipated increased revenues that flow from the price increases.

One critical aspect of the proposed settlement is a provision that confers on the tobacco companies a broad degree of immunity from the antitrust laws. A narrowly focused exemption, permitting the firms to collaborate with respect to certain conduct that would curtail advertising to underage smokers, might be appropriate to advance the stated goals of the settlement. But as currently drafted, the antitrust exemption would permit these firms to "jointly confer, coordinate, or act in concert" to achieve all the goals of the settlement. Such sweeping antitrust immunity appears to be unnecessary for implementation of the settlement. Moreover, broadly drafted immunity might permit a variety of activities that would enable the firms to raise prices of cigarettes beyond the level needed to satisfy industry payments under the settlement.

The important conclusions of the report are:

- The major cigarette manufacturers may profit from the proposed settlement by increasing the price of cigarettes substantially above the amount of the annual payments that are to be paid to the public sector. Based on the history of the industry and its current structure, the companies likely would raise prices by at least the per-pack payments they would be required to pay to the public sector under the settlement, even in the absence of an explicit requirement to "pass through" the cost of the payments. Moreover, certain features of the proposed settlement, particularly the antitrust exemption, have the potential to reduce competition and enhance the ability of the cigarette companies to "coordinate" price increases. If so, the industry may be able to increase prices and generate substantial profits.

- Even assuming that prices increase by no more than the annual payments, the major cigarette firms may profit substantially from the proposed settlement through limitations on liability and reductions in advertising and litigation costs. Thus, the industry may be able to achieve significant civil liability limitations for as little as $15 billion ($10 billion in present value, i.e., in current dollars) in reduced domestic operating profits net of income tax. If coordination is enhanced, then they may gain both the liability limits and a significant increase in profits.

- The report provides several possible but uncertain illustrations of the potential effect of the settlement on prices, profits, and public sector revenues, if coordination is enhanced and the firms raise price by more than necessary to simply "pass through" to consumers the amount of the annual payments. Under one scenario, for example, the additional operating profits net of income tax due to enhanced industry coordination could amount to $36 billion over the next 25 years ($16 billion present value). Under another scenario, reflecting substantially more effective coordination than at present, possible additional operating profits net of income tax may be $123 billion over the next 25 years ($56 billion present value).

- Higher prices from more effective coordination would result in larger revenues for the public sector as well as increased operating profits to the cigarette manufacturers.

The public sector would benefit through greater excess profit penalties under the terms of the settlement and greater revenues from federal corporate income taxes. In general, the examples suggest that the companies would keep about two-thirds of the financial benefits of more effective industry coordination, leaving one-third for the public sector.

- The public sector would gain financially from the settlement proposal, although the annual payments made by the cigarette companies will most likely be considerably less than the $368.5 billion "face value" of the proposed settlement. After taking into account the anticipated decrease in the volume of cigarettes sold (resulting from the likely increase in cigarette prices and a general decline in smoking in the U.S.), the public sector could realize revenues from taxes and the settlement payments of about $207 billion ($100 billion present value), assuming the settlement does not make coordination more effective.

- It is difficult to predict with confidence the price of cigarettes or profits to the cigarette manufacturers over 25 years because the nature of competition may be significantly affected by the proposed settlement. This report concludes that prices and profits could increase substantially, over and above what prices and profits would be in absence of any agreement -- particularly because of the present unduly broad scope of the antitrust exemption.

The report has three sections and an Appendix. The first section describes the history and structure of the industry. The second describes certain provisions of the tobacco settlement, highlighting those (such as the antitrust exemption) that might contribute to a lessening of competition. To provide a tangible view of the potential economic effect of the settlement, the third section provides examples of what might happen to prices, profits, and public sector revenues if the settlement is adopted. Although the examples are illustrations rather than predictions, they help to indicate the kinds of effects and the possible magnitude of the effects that may occur if competition is reduced. The Appendix provides a legal analysis of the proposed antitrust immunity for tobacco product manufacturers.

Industry History and Structure

The cigarette industry has been characterized as an oligopoly in which the firms clearly recognize their mutual interdependence. Although no evidence of explicit collusion has been uncovered, economic histories indicate that the cigarette firms have, for long periods, been able to price cigarettes above competitive levels, notwithstanding infrequent episodes of more intense price competition and product innovation.[1]

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[1] As the Supreme Court observed recently when commenting on the pre-1980s industry: "The (continued...)

Several structural factors support the industry's ability to raise prices above competitive levels. First, there are relatively few firms. Currently, there are only five significant firms and three (Philip Morris, R.J. Reynolds, and Brown & Williamson) account for about 90 percent of the market. Second, overall demand by adults for cigarettes is relatively insensitive to changes in price. Third, the industry is well insulated from entry by new firms. There has been some entry by extremely small firms but none of these firms has garnered a significant competitive presence. Finally, the opportunity for firms tacitly to coordinate price increases is enhanced because changes in price can be quickly matched by rival firms, making price-cutting an unprofitable short-run strategy.

The industry, however, while not an example of perfect competition, is pricing cigarettes today below the price that would be chosen by the industry if the companies were behaving as a perfect cartel. Firms that prefer a relatively low price, for example, may effectively limit the ability of their rivals to increase prices in a coordinated fashion.

The settlement could have an important effect on competition in this market. It has the potential to enhance the ability of these firms to coordinate their actions. In particular, as currently drafted, the antitrust exemption may allow explicit discussions of pricing and may also allow the firms to find means to tacitly collude or to induce reluctant firms to raise prices.

More effective coordination could have significant consequences. Any factors that enhance the firms' ability to coordinate likely would result in much larger price increases than would be associated with a simple pass-through of the settlement payments. While a substantial price increase in cigarettes may be contemplated as one immediate goal of the proposed settlement, the amount of the resulting price increase could be higher than the cost to industry of the settlement payments, resulting in higher industry operating profits.

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cigarette industry . . . has long been one of America's most profitable, in part because for many years there was no significant price competition among the rival firms. . . . List prices for cigarettes increased in lock-step twice a year, for a number of years, irrespective of the rate of inflation, changes in the cost of production, or shifts in consumer demand." Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 213 (1993)(citation omitted).

Analysis of Specific Terms of the Settlement

The report analyzes the effects of various aspects of the settlement on prices and competition. One of the most important aspects of the settlement is an annual payment structure which specifies certain levels of payments, beginning at $8.5 billion in 1998, increasing to $15 billion in 2002, and remaining stable thereafter. The precise amount of the annual payments is linked to the volume of cigarettes sold each year and industry profits.

The report observes that there is reason to believe that cigarette prices will increase by more than is necessary simply to "pass through" the annual payments to consumers. First, many economic studies have demonstrated that the industry has effectively passed through to consumers the full amount of federal and state excise tax increases in the past. Based on this history, the report observes that at least 100 percent of the annual payments will likely be passed through. Second, the settlement has the potential to make future coordination between the firms simpler and this, in turn, would better facilitate the achievement of opportunities for price increases. These two factors suggest that the firms could raise price substantially more than the minimum necessary to pass through the settlement payments to consumers, and thus the overall "price-increase ratio" could be much higher than 100 percent.

Three aspects of the settlement have the potential to enhance the ability of firms to coordinate price levels, and thus to facilitate price increases. First, the settlement contains a broad antitrust exemption. Although this exemption is intended to enable the firms to coordinate activities to reduce youth smoking, it may also permit the industry members to discuss pricing arrangements or other agreements that will have the effect of increasing prices. The exemption, as written, may increase the likelihood that prices will move closer to what a monopolist would charge. An Appendix to the report provides more specific analysis of the exemption.

Second, the settlement imposes important restrictions on advertising and marketing intended to reduce the access and appeal of cigarettes to youth. The settlement imposes these and other restrictions as a means to achieve public health goals. Nevertheless, it should be recognized that advertising and marketing are important competitive tools. Advertising and promotion make it easier for new entrants or maverick firms with new products, lower priced products, or new brands to gain market share from the other firms in the market. As a result, restrictions on marketing could raise barriers to entry and expansion and ultimately lead to higher prices.

Third, the settlement could have a disproportionate effect on the small firms at the fringe of the market as well as potential entrants. For example, the settlement envisions that the non-participating firms will pay almost 50 percent higher annual payments over the life of the settlement than would be required if they had decided to participate in the settlement. These payments would be placed in an escrow account and could be reclaimed, with interest, 35 years later if not paid out in liability payments. Because of the difficulty of predicting the amount of future liability payments and the long delay before any money could be reclaimed, these payments will likely be viewed as non-refundable costs of doing business. As a result, they could substantially raise the marginal costs borne by small firms and potential entrants, and may make it less likely they can effectively compete in the market.

Impact of the Settlement

To gauge the economic impact of the settlement on cigarette prices, quantity sold, retail sales revenues, cigarette manufacturing industry profits, and public sector revenues, the report provides several examples of possible outcomes. The report looks at several variables including (1) the extent to which cost increases have historically been "passed through" to consumers, (2) the level of competition and any change in that level of competition as a result of the settlement, (3) the reduction in advertising expenses and the reduction in litigation expenses, and (4) the consumer responsiveness to price increases. The examples are reported in Section III of the report.

The most critical factor is the ability of the firms to coordinate their actions as a result of the settlement. This factor is captured by the price-increase ratio. In the hypothetical examples analyzed below, industry operating profits decline if the firms are simply able to pass through 100 percent of the implicit tax increase, without achieving higher prices through a lessening of competition among the firms. Under such circumstances the price-increase ratio would be 100 percent. Operating profits increase, however, if coordination is made more effective and if, in consequence, the price-increase ratio is 125 or 200 percent. Assuming a 200 percent price-increase ratio, a possible but uncertain event, operating profit levels are over $123 billion higher ($56 billion in present value) than in the 100 percent price-increase ratio case. A 200 percent price-increase ratio augments public sector revenues by $73 billion ($33 billion in present value) in the example relative to the case in which the ratio is only 100 percent, reflecting the historical rate at which the industry passes through cost increases to consumers without any additional price increase resulting from improved coordination.

The hypothetical examples emphasize that as coordination is enhanced and the price-increase ratio rises, significant incremental profits and revenues are generated for industry and the public sector, respectively. The allocation of those additional monies between industry and the public sector, however, is quite unequal: about 2/3 of the resulting additional profits would be retained by the firms and 1/3 would go to the public sector in corporate taxes.

Finally, it is unlikely that the proposed settlement will generate the $368.5 billion "face value" that has been posited as the public sector's gain from the settlement payments. After taking into account the anticipated decrease in the volume of cigarettes sold resulting from the likely increase in cigarette prices and a general decline in smoking in the U.S., the examples indicate that public sector revenues, including taxes along with the new payments proposed by the settlement, could increase by about $207 billion ($100 billion present value) even if the settlement does not make coordination more effective.

Further Information

Questions about this report should be directed to Jonathan B. Baker, Director of the Bureau of Economics, at (202) 326-2930.

Competition and the Financial Impact of the Proposed Tobacco Settlement

I. Overview of the U.S. Cigarette Industry

Since the early years of the 20th century, the U.S. cigarette industry has comprised four to six major firms. Currently, five major firms -- Philip Morris, Inc., R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation (B.A.T Industries), Lorillard, Inc. (Loews), and Liggett Group, Inc. -- produce over 99 percent of cigarettes sold in the U.S.[1] Overviews of the industry indicate that U.S. cigarette firms may have been able to set price above the level consistent with fully competitive behavior. Nonetheless, the history of the industry reveals instances of relatively more intense price or product competition. The inability of the industry to achieve full coordination that would lead to pricing approaching the monopoly level is probably attributable primarily to the inability of the firms to harmonize fully their divergent interests.

A. Brief History of the Cigarette Industry

Since its beginnings in the early 1900s, the U.S. cigarette industry has exhibited the characteristics of an oligopoly -- an industry comprising relatively few firms, each of which recognizes the interdependence of its actions with those of other firms. When such an industry is largely free from the threat of new competition by entrants, economic theory predicts that prices likely will exceed competitive levels. These supracompetitive prices could reflect coordinated behavior among industry participants,[2] although -- given the small number of competitors in this market -- supracompetitive prices also could emerge even absent coordinated behavior among

[1] The remainder of the market is divided among over 100 smaller manufacturers and importers.

[2] Coordination as discussed here does not require explicit agreements, and thus does not necessarily constitute a violation of the antitrust laws. As the Horizontal Merger Guidelines note (sec. 2.1, p. 18), "coordinated interaction includes tacit or express collusion, and may or may not be lawful in and of itself." U.S. Department of Justice and the Federal Trade Commission, Horizontal Merger Guidelines 18 (Apr. 2, 1992). Economic theory indicates that even without explicit coordination, the pricing that emerges from repeated oligopoly interaction can readily exceed the prices that firms would charge in settings where repeated interaction does not occur. See, e.g., J. Tirole, The Theory of Industrial Organization 239-276 (1988).

the members.[3,4] In many periods including the 1950s through the 1970s, prices were generally stable or rising, with few outbreaks of more intense competition.

During other periods, however, prices and product innovation were less predictable. For example, lower-priced "ten-cent" brands were introduced at the start of the Great Depression as firms saw an opportunity to serve price-sensitive customers after the major cigarette makers had raised prices.[5] Another period of competitive instability, involving new products and unstable prices, occurred when filter cigarettes were introduced in 1953-55. Price variation also increased in the early 1980s, with the introduction of discount cigarette brands.[6] In 1980, Liggett introduced generic cigarettes that were sold with simple, plain labels and were priced 25 to 40 percent below the traditional full-priced premium cigarettes. This action was followed in 1984 by the introduction of branded discount cigarettes by Reynolds. These brands were priced between the generic and premium segments, packaged traditionally, and given greater marketing support than generics. Five years later, in 1989, Liggett introduced yet another category of discounted cigarettes, the deep-discount brands, that were priced below generics.[7]

Notwithstanding the price competition from discount brands during the period from 1980 to 1992, average cigarette prices appeared to rise faster than costs, and the price gap between the premium and discount brands grew through 1992.[8] A major alteration in that pattern of price

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[3] See, e.g., J Tirole, supra note 2, ch. 5.

[4] Histories of the cigarette industry tend to support the possibility of supracompetitive pricing. D. Greer, Industrial Organization and Public Policy 278-279 (3rd ed., 1992); R. Kluger, Ashes to Ashes 43-53 (1996). The success of the Tobacco Trust was short circuited by an antitrust challenge and its subsequent dissolution into four separate firms. See F. M. Scherer and D. Ross, Industrial Market Structure and Economic Performance 250-251 (3rd ed., 1990) and R. Schmalensee, The Economics of Advertising 125-133 (1972).

[5] Various discount brands were introduced to undercut the major brands. "Battle Ax" and other colorful "fighting" brands introduced by the majors were successful in curbing the new entries. Scherer and Ross, supra note 4, at 250-251; Schmalensee, supra note 4, at 125-133.

[6] Scherer and Ross, supra note 4, at 250-251.

[7] The advent of the various discount cigarette brands and the resulting reactions of the other cigarette producers led to the litigation that culminated in the Supreme Court's Brooke Group predatory pricing decision in 1993. Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 213 (1993). For analysis and discussion, see J. Baker, Predatory Pricing After Brooke Group: An Economic Perspective, 62 Antitrust L.J. 585-606 (1994).

[8] C. F. Howell et al., Pricing Practices for Tobacco Products, 1980-94, 117 Monthly Lab. Rev.
(continued...)

increases occurred on "Marlboro Friday," April 2, 1993, when Philip Morris led a price move to narrow the gap between pricing tiers by decreasing prices for its premium brands about 20 percent and increasing prices for its discount brands. Just prior to that event, discount brands accounted for over 40 percent of the overall cigarette market. After that time, the share of discount brands quickly eroded to less than 30 percent as consumers shifted back toward the now relatively less expensive premium brands. The previous pattern may be returning, however, as Philip Morris appeared to lead the most recent industry-wide price increase.[9]

Today, sales are concentrated in a small number of firms controlling 99 percent of a $45 billion U.S. market. As indicated in Table 1, owing largely to its Marlboro brand, which grew rapidly since the late 1960s, Philip Morris is the largest firm with a domestic share of forty-eight percent of cigarettes sold. Reynolds, with twenty-five percent of the market, and Brown & Williamson, with seventeen percent, follow.[10] Lorillard has about eight percent of the market. A fifth firm, the Liggett group, has a share of about two percent. Numerous other smaller firms also sell in the U.S. cigarette market. Although these smaller companies have a combined market share of less than one-tenth of a percent, the entry that has occurred in the industry has come in this small-firm segment.

B. Structural Features Encouraging Industry Coordination

As described above, the industry has historically experienced periods of both stability and instability in pricing. Prices appear frequently to have been less than fully competitive, although episodes of more competitive pricing have also been observed. This section examines some

[8](...continued)
3-16 (1994). BAT's economic expert in the 1994 BAT/American Tobacco Co. merger case accepted that the industry was appropriately characterized as a tightly coordinated oligopoly prior to 1980 and that prices and profits apparently rose during the 1980s as the industry became further concentrated. Testimony of Dennis Carlton concerning industry history, FTC v. B.A.T Industries p.l.c., 94 Civ 7849 (filed Oct. 31, 1994, S.D.N.Y.) (Tr. 01086-01087, Dec. 1994).

[9] See Glenn Collins, Cigarette Makers Are Increasing Prices by Record Amount, New York Times, Sept. 3, 1997, at A1.

[10] The most recent significant change in industry structure occurred in 1994, when B.A.T Industries (the owner of Brown & Williamson) proposed to acquire American Tobacco. The FTC challenged the acquisition on antitrust grounds. A settlement was reached in April 1995, while the case was in trial. Under the settlement, BAT agreed to divest certain assets including brand names (Montclair, among others) and production facilities. That divestiture was completed in October 1996. See FTC v. B.A.T Industries p.l.c., 94 Civ 7849 (filed Oct. 31, 1994, S.D.N.Y.).

structural features of the cigarette market that might influence the firms' incentives and ability to reach and maintain a coordinated outcome, leading to less than fully competitive prices.

Several factors contribute to the ability of firms in the cigarette industry to reach and maintain an implicit consensus from which they tend not to deviate. First, most economic models of oligopoly behavior conclude that price-cost margins will be higher as the number of firms decreases. This relationship might arise, for example, if fewer firms tend to have similar interests and incentives and consequently are better able to orchestrate coordinated behavior. As noted above, the same few firms have dominated the cigarette industry for decades,[11] and, as indicated in Table 2, concentration has been high and rising for many years.[12]

Second, the overall demand by adults for cigarettes is inelastic, or relatively insensitive to changes in price. Most adult consumers will continue to smoke notwithstanding a significant increase in price. As a result, an industry-wide price increase would be profitable for the cigarette companies, even though some smokers would react to the higher prices by smoking less or quitting altogether. Even substantial price increases are likely to be profitable, as long as they are made on a coordinated basis.

Estimates of the elasticity of demand for cigarettes, a measure of price sensitivity, are commonly reported to be in the vicinity of -0.4.[13] A demand elasticity of -0.4 indicates that a 1 percent increase in the price of cigarettes will be associated with a 0.4 percent decrease in the number of cigarettes sold. The -0.4 adult demand elasticity estimate is consistent with estimates derived from a variety of studies. Studies of per capita consumption report elasticity estimates in the range of -0.2 to -0.8.[14] This figure also represents the midpoint of the consensus range of

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[11] One long-time industry participant, American Tobacco, was acquired by BAT, the owner of Brown & Williamson, in 1994.

[12] See generally Horizontal Merger Guidelines, supra note 2, at 15-25. The Merger Guidelines define highly concentrated markets as those with a Herfindahl-Hirschman Index ("HHI") of 1800 or above. As Table 2 indicates, the five major firms account for almost 100 percent of cigarette sales in the United States, with a HHI of 3260 in 1996.

[13] Record evidence in the FTC's 1994 challenge of BAT's acquisition of American Tobacco was also consistent with a relatively low demand elasticity. FTC v. B.A.T Industries p.l.c., 94 Civ 7849 (filed Oct. 31, 1994, S.D.N.Y.) (testimony of Lewis Tatem, economic expert for the FTC, Tr. 543-544.)

[14] For reviews of cigarette demand studies see F. Chaloupka and M. Grossman, Price, Tobacco Control Policies and Youth Smoking, (National Bureau of Economic Research, Working Paper No. 5740, 1996); and Surgeon General of the United States, U.S. Department of Health and Human Services, Center for Disease Control and Prevention, Preventing Tobacco Use

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elasticity estimates arrived at by a gathering of economists and other experts convened by the National Cancer Institute (-0.3 to -0.5).[15] Other studies allow for the possibility that smokers consider the future costs of developing a smoking habit when making current decisions to buy cigarettes.[16] Studies based on this approach generally imply price elasticities that are higher over a relatively long period because consumer response to a permanent increase in the price of cigarettes grows over time, until it reaches a final equilibrium. These models, nonetheless, still find that demand is inelastic even in the long run.[17] Applying this future-cost approach to state data, one study reports a short run price elasticity of -0.45 and a long run estimate of -0.75.[18]

Third, unlike in some other industries, changes in product or price are readily observed by all competitors. As a result, cigarette producers may not have effective means for increasing sales substantially before their competitors can respond to any strategic moves. Such marketplace visibility and responsiveness results from several factors. For example, restrictions on cigarette advertising in broadcast media make it difficult for firms to undertake major mass media campaigns, which would probably be the most effective way to launch new brands before

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[14](...continued)
Among Young People (1994).

[15] National Cancer Institute, National Institutes of Health, The Impact of Cigarette Excise Taxes on Smoking Among Children and Adults: Summary Report of a National Cancer Institute Expert Panel (1993).

[16] See G. Becker and K. Murphy, A Theory of Rational Addiction, 96 J. Pol. Econ. 675-700 (1988). For skeptical assessments of this model, see J. Harris, A Working Model for Predicting the Consumption and Revenue Impacts of Large Increases in the U.S. Federal Cigarette Excise Tax (July 1, 1994) (unpublished manuscript); and J. Gravell and D. Zimmerman, Congressional Research Service, Cigarette Taxes to Fund Health Care Reform: an Economic Analysis (1994).

[17] One study indicated that the time period for full adjustment to a new equilibrium might be as long as 69 years, a length of time calculated to allow full adjustment in the age distribution of smokers. See J. Gravell and D. Zimmerman, supra note 16.

[18] G. Becker et al., An Empirical Analysis of Cigarette Addiction, 84 Am. Econ. Rev. 396-418 (1994). Elasticity estimates based on survey data rather than observed consumption decisions tend to suggest demand is even more inelastic than these studies indicate. For example, in a study based on an economic model similar to that employed by Becker et al., using survey data, Chaloupka estimated long run price elasticities between -0.27 and -0.37. F. Chaloupka, Rational Addictive Behavior and Cigarette Smoking, 99 J. Pol. Econ. 722-42 (1991). Analysis of a similar database of survey respondents by Wasserman et al., resulted in a price elasticity estimate for adults of -0.28 for 1988. W. G. Wasserman et al., The Effects of Excise Taxes and Regulations on Cigarette Smoking, 10 J. Health Econ. 42-64 (1991).

their rivals could react.[19] Marketing campaigns using less effective media are likely to be observed and responded to before they have a major impact on sales. Even the introduction of generic cigarettes, which was largely undertaken without traditional marketing support, was highly visible to competitors. In addition, price cutting to distributors likely would be observed directly (to the extent distributors are shared) or indirectly (in the form of lower prices to consumers).[20] In either case, rivals would be able to respond quickly to any price reductions, making "hit-and-run" price cuts unattractive as a strategy for increasing firm profits.[21] Accordingly, short-term deviation from the terms of a coordinated understanding on price and other competitive dimensions can be expected to be quickly observed and quickly countered, and therefore to be unprofitable for the industry participants.[22]

But: Marlboro Friday

A fourth structural feature of the market is that entry does not significantly constrain market power. That is, entry of additional firms into the market (or its prospect) is unlikely to upset the stability of a coordinated pricing strategy. Despite increasing prices and increasing profit margins, as discussed below, the new firms that have recently entered the cigarette market have failed to garner significant shares to date. Although the absence of significant entry does not definitively demonstrate that incumbent pricing is unconstrained by new competition from entrants, characteristics of the cigarette market make entry difficult. For example, current restrictions on advertising may fall particularly hard on entrants or other firms seeking to expand rapidly. To the extent firms are less able to inform consumers about the availability and the attributes of their products or brands, they likely will be less able to be successful in the marketplace and likely will place less of a constraint on the behavior of the established firms.

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[19] Schmalensee, supra note 4, at 125-133.

[20] After Marlboro Friday, Philip Morris established a large scale "Master" program in which retailers submitted information to Philip Morris regarding other cigarette manufacturers' discount offers and volume in return for discounts from Philip Morris. FTC v. B.A.T Industries p.l.c., 94 Civ 7849 (filed Oct. 31, 1994, S.D.N.Y.) (testimony of Lewis Tatem, economic expert for the FTC, Tr. 548-49).

[21] Similarly, large buyers in some markets may be able to induce lower prices by reducing their own demand for a product, but this does not seem to be a factor in the U.S. cigarette industry. Retailing of cigarettes is extremely diverse with hundreds of thousands of outlets. With such ubiquitous distribution, it is unlikely that any buyers have large enough shares to make secret price-cutting profitable or otherwise exercise buyer power.

[22] Given that deviations from an implicit consensus would likely be unprofitable, the main impediment to more effective coordination among cigarette producers is likely the difficulty in harmonizing divergent interests to reach such a consensus in the first instance, as discussed below. This is not to say that alterations in the consensus will not occur over time, for example in response to exogenous shocks to the market or the development of innovations that cannot be quickly copied and that alter the long-term strategies of individual firms in divergent ways.

Under the proposed settlement, restrictions on advertising will be substantially tightened, making entry still more difficult.

In addition, three decades of stagnant or declining industry demand have reduced the attractiveness of the cigarette industry to prospective entrants. Until the intensification of health concerns in the 1960s,[23] cigarette smoking was a ubiquitous and growing feature of American culture during the 20th century. Since that time, the market for cigarettes in the U.S. has decreased significantly. U.S. cigarette consumption per capita declined from a peak of 4,345 cigarettes in 1963 to 2,505 in 1996 (Table 3). The proportion of smokers among adults has also dropped from peak of 42.6 percent in 1966 to 25.5 percent in 1994.[24] Even in the face of some media marketing restrictions and generalized demand declines, however, small firms have continued to enter niches of the cigarette industry. Although none of these firms has grown to the point that its market share is significant, they appear to be a permanent feature of the market.[25]

C. Evidence of Market Power from Industry Conduct

The Supreme Court has recognized a pattern of coordinated interaction in past cigarette industry practices.[26] Price and cost patterns during the post-1980 period also suggest that the cigarette oligopoly may not be performing competitively. The rise in prices during this period has been extensive, increasing at a much higher rate than the general price level. As shown in

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[23] These concerns led to the report by the Surgeon General's advisory committee on January 11, 1964. Health concerns were also raised in the early 1950s. The introduction of filter cigarettes was closely related to these early expressions of concern about the health effects of cigarette smoking. Kluger, supra note 4, at 148-182, 258-262.

[24] Centers for Disease Control <www.cdc.gov/nccdphp/osh/prevail.htm>. The smoking rate among men reached 56.9 percent in the 1950s. The rate among women peaked at 33.9 percent in 1965 and 1966.

[25] However, as discussed below, some features of the settlement could harm this market segment, potentially causing it to disappear.

[26] The three major cases are Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993), American Tobacco Co. v. United States, 328 U.S. 781 (1946), and United States v. American Tobacco Co., 221 U.S. 106 (1911). Discussing the pre-1980 market for cigarettes, the Supreme Court in Brooke Group stated that "the cigarette industry . . . has long been one of America's most profitable, in part because for many years there was no significant price competition among the rival firms. . . . List prices for cigarettes increased in lock-step twice a year, for a number of years, irrespective of the rate of inflation, changes in the cost of production, or shifts in consumer demand." Brooke Group, 509 U.S. at 213 (citation omitted).

Table 4, inflation-adjusted prices rose from $1.20 per pack in 1980 to $1.85 per pack in 1996.[27] While some of this price rise is a product of rising costs (including state and federal taxes), it appears that a significant portion may not be cost related. Comparing the rise in cigarette prices to costs for the 1980-94 period, one analysis concludes that "escalating prices for cigarettes cannot be attributed to higher input costs."[28] The tendency for price rises to consistently outpace cost increases is unlikely to be observed in a fully competitive market over a long-term period.[29]

Consistent with the price and cost data, the publicly available evidence suggests that the cigarette industry has been relatively profitable.[30] Also, profit margins for the industry based on Census data show a rising trend over the 1980-94 period -- even in the face of declining demand.[31] This upward trend in profit margins halted, however, due to price declines in the

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[27] Since Marlboro became the clear leading brand in the late 1970s, Philip Morris has typically been the price leader for premium-priced cigarettes, and Philip Morris led the most recent price increase. Scherer and Ross, supra note 4, at 250-251; FTC v. B.A.T Industries p.l.c., 94 Civ 7849 (filed Oct. 31, 1994, S.D.N.Y.) (testimony of Lewis Tatem, economic expert for the FTC, Tr. 544-545); and Glenn Collins, Cigarette Makers Are Increasing Prices by Record Amount, New York Times, Sept. 3, 1997, at A1. While prices increased for all brands, price increases for the discount brands lagged behind those for established premium brands.

[28] C. Howell, F. Congelio, and R. Yatsko, Pricing Practices for Tobacco Products, 1980-94, 117:12 Monthly Lab. Rev. 3 (1994). The authors generated an input cost series from Census (material, labor and capital) and FTC (advertising and marketing) data. They did not specifically include state and federal taxes in their calculations, but the addition of these two components does not change the general result that prices rose at a much greater rate than costs. Thus on a per unit basis, input costs plus federal and state excise taxes rose 87 percent over the 1980-94 period compared to a corresponding increase of 179 percent in nominal prices.

[29] Scherer and Ross, supra note 4, at 339-347.

[30] Industry surveys based on SEC 10K submissions generally show the industry as displaying profit rates above the overall industry norm. See, e.g., the annual "Beverages and Tobacco" survey in Forbes Magazine. The exact translation between the concepts of accounting profits and economic profits is subject to considerable debate, however. Compare F. Fisher, and J. McGowan, On the Misuse of Accounting Rates of Return to Infer Monopoly Profits, 73 Am. Econ. Rev. 82-97 (1983) with W. Long and D. Ravenscraft, The Misuse of Accounting Rates of Return: Comment, 74 Am. Econ. Rev., 494-500 (1984).

[31] In this analysis, profit margins are gross margins as a percentage of value of shipments. Data came from the following sources: Federal Trade Commission, Report to Congress for 1994 Pursuant to the Federal Cigarettes Labeling and Advertising Act 15-18 (1996); U.S. Department of Commerce, Bureau of the Census, Tobacco Products, in 1992 Census of Manufacturers 21A-7

(continued...)

aftermath of Marlboro Friday in 1993. In addition to the evidence on prices, costs and profits, econometric studies of pricing behavior in the cigarette industry have produced results consistent with the view that the cigarette industry is not fully competitive, though also consistent with the view that the level of market-sharing coordination is not high.[32]

D. Imperfect Coordination and Divergent Firm Incentives

While the structural and behavioral evidence cited above is consistent with the possibility of coordination among the major cigarette producers, it is also clear that any such coordination is far from complete.[33] This is immediately evident from the econometric estimates of the industry demand elasticity, cited above, which suggest that adult demand is inelastic at prevailing prices. Because a monopolist facing inelastic demand would find it profitable to raise price until it reaches elastic portions of the industry demand curve and this has not occurred, we can infer that coordination is imperfect.[34] The occasional outbreaks of more intense price or product competition also suggest incomplete coordination.

Other evidence of incomplete coordination comes from the long-term shifts in market share that have occurred in the cigarette industry. Market shares covering the period from 1947 to 1996 are displayed in Table 5. Philip Morris, now the leading firm with the leading brand, has gained share from less than 10 percent to over 47 percent currently. Liggett and American both

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[31](...continued)
(1995). The Census figures include the value of shipments and costs involved in the production of cigarettes in domestic plants destined for export, while the FTC advertising and marketing data relate only to domestic operations.

[32] D. Sullivan, Testing Hypotheses about Firm Behavior in the Cigarette Industry, 93 J. Pol. Econ. 586 (1985); O. Ashenfelter and D. Sullivan, Nonparametric Tests of Market Structure: An Application to the Cigarette Industry, 35 J. Indus. Econ. 483-498 (1987); P. Barnett et al., Oligopoly Structure and the Incidence of Cigarette Excise Taxes, 57 J. Pub. Econ. 457-470 (1995).

[33] Incomplete coordination is discussed in the Horizontal Merger Guidelines, supra note 2, at section 2.11, p. 20. That section discusses the ability of firms to reach terms of coordination and factors that might make reaching a coordinated outcome more or less likely.

[34] That is, the fact that relatively low demand elasticity estimates are found even using prevailing prices is consistent with the view that cigarette firms are not pricing near the monopoly level. Scherer and Ross, supra note 4, at 250-251. In addition, one estimate of the full-blown monopoly price in cigarettes in 1995 was in the $4.00 range. Prices of cigarettes today are at about half that level. See J. Harris, American Cigarette Manufacturers' Ability to Pay Damages: Overview and a Rough Calculation, 5 Tobacco Control 292-294 (1966).

lost the vast majority of their initial shares over the period. Reynolds is the one major firm that maintained a fairly stable market share over the past 50 years.

The inability of the cigarette industry to achieve complete coordination is most likely attributable in large part to partially divergent interests among the firms. Firm interests may diverge for a number of reasons.

First, product innovation may affect some firms more than others. Product competition has historically taken the form of innovations in product design, such as the addition of filters during the 1950s.[35] More recently, low-tar cigarettes were developed during the early 1970s,[36] and unbranded generic cigarettes were reintroduced in the early 1980s.[37] These innovations generally favored some firms more than others, and in consequence tended to lead to a more competitive period during which the firms, in effect, identified a new oligopolistic consensus.[38]

Second, as with most products that are not homogeneous, demand for some brands is more price sensitive than is demand for other brands.[39] Similarly, the sales of certain brands may be more sensitive than other brands to variations in the prices of specific rival brands. Moreover, industry participants recognize that the demand for individual brands often has a well-defined "life cycle" -- an initial period of growth in market acceptance, followed by a share plateau, followed by an extended period of share decline. The rise and fall of Lucky Strike, Pall Mall, and later Winston, as Marlboro became the largest brand in the late 1970s, provide examples. A firm with most of its brands in extended decline may have different views about industry pricing than a firm with more brands earlier in the life cycle.[40] As the end of a brand's life cycle approaches, brand demand elasticity may increase above the norm, making a price increase more

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[35] Kluger, supra note 4, at 141-182.

[36] Id. at 190, 273-275, 379-382

[37] Id. at 516.

[38] For example, the introduction of generic brands led to tiered pricing. Premium brands, both established and new, are typically priced well above the discount segment consisting of generic and private label cigarettes and branded discount cigarettes. The extent of the gap between discount and premium brands has varied over time.

[39] Differences in brand elasticities were an important consideration in the FTC's challenge of the 1994 proposal of BAT to acquire American Tobacco.

[40] Differences in brand mix across the life cycle may be responsible, in part, for the major shifts in market share among three of the leading firms over the past forty years.

problematic for firms with declining brands.[41] Since a general price increase will accelerate the decline of the "aged" brands, leading firms with predominantly "aged" brands will likely prefer a lower industry price. The current major brands and the shares of these brands grouped by the five major companies are presented in Table 6.

Third, the most important recent divergence of interest comes from differences in product mix across the firms. Premium brands are the mainstay of four of the five leading manufacturers. In contrast, generic and non-premium brands today account for a far greater fraction of Liggett's sales and profits. Furthermore, there are significant differences among the major firms in their commitment to discount segments.

This commitment is indicated in Table 7, which quantifies the shares of each firm in the various pricing tiers. Philip Morris and Reynolds, the two largest firms in the industry, have approximately 16 percent and 37 percent respectively of their sales in the discount segment, and each does less than a quarter of that in private label and generics. Brown & Williamson, the third largest firm, ranks second in terms of its involvement in the discount segment. A little less than 60 percent of its sales are in the discount segment; however, only about 10 percent of that is due to generic or private label sales. Lorillard, the fourth largest firm, has approximately 5 percent of its sales in the discount segment and none of that is private label. Liggett, the smallest major U.S. cigarette manufacturer, is by far the most intensely involved in the discount segment and most of its discount business is in the low-end generic and private label components. No other major firm comes close to this degree of involvement in the discount segment and the generic/private label subcomponents. These product mix differences across the firms are likely to be an important factor causing divergence of interests among the firms.

E. Current Limits on Coordination

The divergence of interests among cigarette industry participants makes it likely that the firms will differ as to their preferred coordinated price. In particular, firms with a relatively low commitment to the market today (e.g., low share of current sales) but with a relatively high ability to expand (e.g., higher capacity share or other ability to expand output) can be expected to prefer an industry price well below the monopoly price.[42]

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[41] The differences in pricing incentives based on differences in rates of decline in premium brands were a theme of the FTC presentation in its challenge of BAT's acquisition of American Tobacco. FTC v. B.A.T Industries p.l.c., 94 Civ 7849 (filed Oct. 31, 1994, S.D.N.Y.) (testimony of Lewis Tatem, economic expert for the FTC, Tr. 534-535).

[42] See J. Baker, Two Sherman Act Section 1 Dilemmas: Parallel Pricing, the Oligopoly Problem, and Contemporary Economic Theory, 38 Antitrust Bull. 143, 202-207 (1993); and J. Baker, supra note 7, at 585-606, particularly at 599-602. The discussion in the text assumes that (continued...)

In this setting, the seller with the lowest preferred price acts as a constraint on increases in the industry price (so long as that firm can significantly expand output if price exceeds its preferred level).[43] Its rivals recognize that efforts to raise prices above what the constraining firm prefers would not be successful.[44] If that constraining firm could obtain a larger commitment to the current market or could be induced to raise the price it prefers,[45] however, then the constraint on industry pricing would be relaxed and prices would rise. Industry instability -- as reflected in price wars or other episodes of apparently more intense competition -- occurs when shifts in buyer preferences, changes in seller costs, variation in public policies, new product developments, or other exogenous factors lead one of the industry firms to prefer a new, lower, industry-constraining price. Under such circumstances, factors that eliminate the seller with the lowest preferred price or encourage that firm to prefer a higher price level likely will lead to a higher industry price.[46]

During the 1980s, for example, Liggett first and American (now part of Brown & Williamson) later came to prefer a lower industry price. Both firms' major brands increasingly were older, declining, and near the end of their life cycles. Market shares declined for both

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[42](...continued)
side payments are unavailable, and adopts the view that the threat of a reversion to competition is sufficient punishment to support high prices.

[43] For decades the cigarette industry has contained many tiny firms, though none has grown to garner any noticeable market share. Currently the non-majors account for less than one-tenth of one percent of industry output. These firms may have an ability to expand output that is comparable to that of a de novo entrant.

[44] Such a firm has been called a "maverick." Horizontal Merger Guidelines, supra note 2, at 21-22. The use of the term "maverick" in the Merger Guidelines is broader than the way the term is often employed elsewhere, because the seller with the lowest preferred price need not necessarily engage in price-cutting behavior in order to constrain the prices charged by its competitors.

[45] Rivals might induce the constraining firm to prefer a higher price by developing a scheme to compensate the maverick or by finding a way to raise the maverick's marginal costs, for example.

[46] As discussed further in Section II, the antitrust immunity envisioned in the settlement might allow firms to devise compensation schemes and the extra payments required of non-participating firms might increase the marginal cost of the firms that now constrain industry pricing. The proposed tobacco settlement may contain provisions that will alter the price preferences of the firm that currently prefers the lowest price.

firms.[47] Each turned to discount and generic brands as a means of expanding sales.[48] Introducing new brands at a lower price point or switching old brands to a new, lower price point thus became an attractive strategy, first for Liggett and later for American.[49] In this way, Liggett and American became the constraints on industry pricing. The major firms responded initially by selling discount brands as well[50] and later by lowering the relative price of premium brands on "Marlboro Friday." Thus the industry came to recognize that the coordinated price could not be maintained above the level preferred by Liggett and American.[51] With the acquisition of American Tobacco by BAT, Liggett remains the only firm of significant size that has an appreciably older brand portfolio in terms of premium-brand life cycles and a primary commitment to the discount segments of the cigarette market. This likely makes Liggett one of the most significant constraints on higher industry pricing today.

The success of industry efforts to attain and maintain a coordinated price in the future will depend upon the extent to which the incentives of the constraining firm or firms diverge from the individual incentives of the remaining major producers. As discussed in the next section, the tobacco settlement has the potential to allow the major firms to coordinate their actions more effectively.

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[47] Liggett's older premium brands include L&M, Chesterfield, and Lark. American's older premium brands included Pall Mall and Raleigh.

[48] American, for example, developed its own unique and promising approach to product distribution in introducing discount brands in the late 1980s. FTC v. B.A.T Industries p.l.c., 94 Civ 7849 (filed Oct. 31, 1994, S.D.N.Y.) (testimony of Dennis Carlton, economic expert for BAT, Tr. 1052).

[49] Introducing new premium brands may have become problematic for these firms with various restrictions on advertising of cigarettes on television.

[50] This response led to the Brooke Group litigation, where Brown & Williamson was the primary defendant. At the time of the alleged predatory behavior, evidence suggested that Brown & Williamson was the only other cigarette manufacturer with a substantial presence in the discount segment. See J. Baker, supra note 7, at 595.

[51] Philip Morris led the "Marlboro Friday" pricing move. Within a short time, most of the other firms raised discount prices and lowered premium prices to narrow the gap between the pricing tiers, as Philip Morris had done. American failed to follow the leader for an extended period of time. R. Margulis, The War of '93, Apr. 1994 Tobacco Rep. 22-24. Liggett was already viewed as outside the cooperative group with respect to the generic segment.

Table 1
U.S. Cigarette Company
Domestic Shares and Volume, and Exports
1996

Firm	Domestic Share of Cigarettes Sold 1996	Domestic Volume in 1996 (billions of cigarettes)	Export Volume in 1996 (billions of cigarettes)
Philip Morris	47.8%	230.84	173.59
Reynolds	24.6%	119.08	43.90
Brown & Williamson	17.2%	83.35	41.79
Lorillard	8.4%	40.40	--
Liggett	1.9%	8.95	.48
Others	0.1%	.68	--
Industry Total	100.0%	483.30	269.76

Source: John C. Maxwell, Market Up, Apr. 1997 Tobacco Rep. 22.

Table 2
Concentration Trends

Year	HHI	Number of Major Firms
1930	2682	5
1950	2249	6
1970	2066	6
1980	2421	6
1990	2880	6
1993	2939	6
1994	2964	6
1995 (American + B&W)	3179	5
1996	3260	5

Sources and Notes: Data for 1930 to 1993 are taken from Exhibits PX345 and PX336-E used during the cross examination of Dr. Dennis Carlton in FTC v. B.A.T Industries p.l.c. et al., 94 Civ 7849 (filed Oct. 31, 1994, S.D.N.Y.), Tr. 1086-1087. BAT is now the owner of both Brown & Williamson Tobacco (B&W) and American Tobacco. Data for 1994 to 1996 are calculated from market share data in Maxwell, Market Up, Apr. 1997 Tobacco Rep. 22. HHI is an index of market concentration calculated by squaring the market share of each firm and adding the resulting products together across all firms. Market shares are measured in terms of units sold in the U.S. Markets with HHI statistics above 1800 are classified as highly concentrated under the April 1992 joint DOJ/FTC Horizontal Merger Guidelines.

Table 3
U.S. Per Capita
Cigarette Consumption
1935-1996

Year(s)	Number of Cigarettes Per Capita
1935-1939	1,779
1940-1944	2,558
1945	3,449
1950	3,522
1955	3,597
1960	4,171
1965	4,259*
1970	3,985
1975	4,123
1980	3,849
1985	3,370
1990	2,826
1994	2,524
1995	2,505
1996	2,482

Notes: Economic Research Service, U.S. Department of Agriculture, Tobacco Situation and Outlook Report, various issues.
* The peak year was 1963, with average per capita consumption of 4,345.

Table 4
Inflation-Adjusted Price
per Package of Cigarettes
1980 to 1996

Year	Price Per Pack in 1996 dollars
1980	$1.20
1981	$1.20
1982	$1.33
1983	$1.49
1984	$1.48
1985	$1.52
1986	$1.58
1987	$1.64
1988	$1.72
1989	$1.82
1990	$1.84
1991	$2.00
1992	$2.05
1993	$1.84
1994	$1.86
1995	$1.85
1996	$1.85

Source: Tobacco Institute, The Tax Burden on Tobacco (1996).

Table 5
Cigarette Company
Market Shares
(percent)
1947-1996

Year	Philip Morris	Reynolds	Brown & Williamson	Lorillard	Liggett	American Brands
1947	7.0	29.7	3.2	4.3	21.3	34.5
1952	9.6	27.3	6.0	6.3	18.0	33.0
1957	9.3	28.7	10.7	7.7	14.5	29.1
1962	9.4	35.0	9.3	11.0	9.8	25.6
1967	12.7	32.5	14.3	10.2	8.1	22.2
1972	20.0	31.4	17.3	8.9	5.6	16.8
1977	26.7	33.1	15.8	8.7	3.4	12.3
1982	32.9	33.6	13.4	8.6	2.9	8.8
1987	38.4	32.1	10.9	8.2	3.5	6.9
1992	40.9	29.5	12.2	7.4	3.1	6.9
1993	40.5	31.5	11.3	7.3	2.5	6.9
1994	44.8	26.7	11.3	7.5	2.3	7.4
1995	46.1	25.7	18.0	8.0	2.2	*
1996	47.8	24.6	17.2	8.4	1.9	*

Source: Robert Porter, The Impact of Government Policy on the U.S. Cigarette Industry in Empirical Approaches to Consumer Protection Economics 463 (P. Ippolito and D. Scheffman, eds., Mar. 1986, Bureau of Economics Conference, Federal Trade Commission). Data for 1947-1982 is based upon data from Schmalensee, supra note 4 and various issues of Business Week. Data for 1987-1996 update Porter's statistics and are taken from J. Maxwell, 1995 Maxwell Tobacco Fact Book, and Tobacco Rep. various issues.

* American Brands was acquired by Brown & Williamson in late 1994.

Table 6
1996 U.S. Cigarette Industry: Leading Premium Brand Sales by Firm

Firm	Leading Brand (share)	2nd Leading Brand (share)	3rd Leading Brand (share)	4th Leading Brand (share)
Philip Morris	Marlboro (32.3)	Virginia Slims (2.4)	Merit (2.3)	Benson & Hedges (2.3)
Reynolds	Winston (5.3)	Camel (4.6)	Salem (3.6)	Vantage (1.1)
Brown & Williamson	Kool (3.6)	Carlton (1.3)	Pall Mall (1.1)	Capri (.6)
Lorillard	Newport (6.1)	Kent (.8)	True (.4)	Style (.3)
Liggett	Eve (.2)	L&M (.1)	Chesterfield (.1)	Lark (.1)

Source: John C. Maxwell, Market Up, Apr. 1997 Tobacco Rep. 22-28.

Table 7
1996 U.S. Cigarette Industry: Participation by Segment

Firm	Firm's Share of U.S. Cigarette Unit Sales	Proportion of Firm's Sales in the Premium Price Segment	Proportion of Firm's Sales in the Discount Price Segment	Proportion of Firm's Sales in the Discount Segment Due to Generic and Private Label Sales
Philip Morris	47.8%	84.4%	15.6%	12.2%
Reynolds	24.6%	63.0%	37.0%	22.9%
Brown & Williamson	17.2%	42.9%	57.1%	10.7%
Lorillard	8.4%	93.7%	6.3%	--
Liggett	1.9%	25.3%	74.7%	80.1%
Industry Totals	100%	71.5%	28.5%	

Source: John C. Maxwell, Market Up, Apr. 1997 Tobacco Rep. 22-28.

Note: Premium priced cigarettes are the traditional brands whose prices are similar. The discount segment includes all non-premium priced cigarettes. This includes the branded discount category, generic cigarettes, and private label brands. Private label brands are those produced for distribution and sale by other firms under their own label.

II. Competition and the Expected Effects of the Proposed Settlement

The proposed settlement has the potential to affect almost all aspects of cigarette industry behavior and performance. This section focuses on the provisions in the settlement with the greatest potential to affect competition in the industry and the effects that these competitive changes might be expected to have on market prices.[52]

A. Selected Settlement Terms and Their Potential Effect on Competition

1. **Annual Payment Structure.** An important element of the settlement is the annual payment structure.[53] The settlement specifies "Annual Payments" that increase in face value to a maximum of $15 billion in 2002 and following years (Title VI, pp. 34-35). Unlike the initial payment due at signing, these payments are not fixed in value, but instead vary according to the volume of cigarettes sold each year and industry profits.[54] Specifically, if the volume of cigarettes sold is less than the volume of sales in the base year, then the annual payment is reduced by the same proportion.[55,56] For example, if sales decline by 20 percent in the year 2002

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[52] This report does not analyze the consequences of the proposed settlement for other domestic industries using tobacco products such as smokeless tobacco. Nor does it examine the impact of the settlement on tobacco farming.

[53] The proposed settlement also requires a fixed $10 billion payment from the industry due at signing (Title VI.A, pp. 34-35). The settlement does not specify how this payment will be apportioned among firms in the industry, but if it is shared by all, it could weaken the smallest or more marginal firms in the industry disproportionately. If, in consequence, the firms that help constrain the major producers are led to exit the industry, the result would be to relax the competitive constraints faced by the major firms. Alternatively, if the initial payment is paid entirely by the largest tobacco firms, then concerns about competitive effects from this provision would be mitigated.

[54] The payments are also adjusted for inflation.

[55] Similarly, if cigarette sales should rise relative to the base year, the annual payments will proportionately increase. This outcome is less likely to occur, however, since the settlement will cause cigarette prices to rise and demand is expected to fall.

[56] The settlement specifies that "adult" sales volumes will be used in calculating any proportional reductions in the payment and that total sales volumes, including both adult and youth volumes, will be used in calculating any proportional increases. This distinction is not empirically relevant since sales to adult smokers, defined as ages 18 and over, account for approximately 98 percent of all cigarettes sold domestically. J. Harris, Comments on Proposed

(continued...)

compared to the base year, then the payment is reduced by 20 percent, from $15 billion to $12 billion. However, if industry profits increase relative to the base year, then the industry will not be permitted to benefit by the full amount of this volume-related payment reduction. Rather, annual payments will be restored by an amount equal to 25 percent of the industry's enhanced profits. Thus, in the example, if industry profits in 2002 are $4 billion greater than in the base year, then 25 percent of $4 billion, or $1 billion, of the annual payment will be restored, bringing it up to $13 billion.

Because the actual size of the annual payment depends on the quantity of cigarettes sold each year, most of the payment can be treated conceptually as an excise tax per pack that will be passed on to smokers. The settlement, (Title VI.B.7, p. 35), envisions that the annual payments will be passed through to consumers in the form of higher prices for cigarettes. Assuming the settlement is enacted in 1997 as drafted, the implicit tax will be approximately 35 cents per pack in 1998, 39 cents in 1999, 48 cents in 2000, 58 cents in 2001, and 62 cents per pack from 2002 on.[57] However, under the Balanced Budget Act of 1997,[58] 10 cents per pack of the federal excise tax on cigarettes will be credited against the Annual Payments of the tobacco industry in the years 2000 and 2001, and this credit will be increased to 15 cents per pack in 2002 and subsequent years. Taking into account this credit, the implicit excise tax would be reduced to 38 cents per pack in 2000, 48 cents in 2001, and 47 cents in 2002. As of this writing the Senate and House have each passed legislation that would rescind the credit against the Annual Payments.[59]

(...continued)
Tobacco Industry-Wide Resolution, Commissioned by the American Cancer Society 5 (June 26, 1997) (unpublished manuscript). For this and other reasons, the analysis infra does not address anticipated effects of the proposed settlement on youth smoking.

[57] For example, when the $15 billion payment is divided by the approximately 24.2 billion packs of cigarettes sold in the base year, it amounts to about 62 cents per pack. Since the payment is volume adjusted, it remains at 62 cents per pack even if sales increase or decrease. However, the 62 cents per pack (and the other per pack figures above) do not include the profit-related adjustment that applies if sales decrease and profits increase. This adjustment can be viewed as a 25 percent tax on each firm's increase in profits assessed in addition to the excise tax of 62 cents per pack. The examples discussed in Section III account for both components of the payment.

[58] Balanced Budget Act of 1997, Pub. L. No. 105-33, 111 Stat. 251 (1997).

[59] Departments of Labor, Health and Human Services, and Education and Related Agencies Appropriations Act of 1998, S. 1061, 105th Cong. 1st Sess. (1997) (Senate bill); Departments of Labor, Health and Human Services, and Education and Related Agencies Appropriations Act of 1998, H.R. 2264, 105th Cong. 1st Sess. (1997) (House bill). If this legislation becomes law, the implicit excise tax will grow to 62 cents per pack as stated above.

The potential effects of that recision on the calculations used in the example are discussed in Section III. D. below.

As discussed below, the competitive conditions in the industry together with the low elasticity of cigarette demand are likely to enable cigarette companies to "pass through" to consumers the full amount of this implicit tax. In addition, other aspects of the settlement have the potential to increase the ability of the major firms to coordinate their behavior, so that the ultimate increase in consumer prices could be substantially higher than that required by the annual payment itself. The additional revenue would be expected to increase both corporate profits and public sector revenues.

2. **Broad Antitrust Immunity.** The settlement gives antitrust immunity to the tobacco companies to coordinate their activities taken "in order to achieve the goals of this Agreement and the Act relating to tobacco use by children and adolescents." (App. IV.C.2, p. 50). The Department of Justice would have review rights subject to this standard. However, the breadth of this language, as currently drafted, may permit the industry members to discuss pricing arrangements that reach beyond the amount of a 100 percent "pass-through" to consumers of the cost of the annual payments.[60] Also, the current language may permit a range of anticompetitive conduct involving non-price restrictions. Thus, the exemption increases the likelihood that prices will move closer to what a monopolist would charge.

As discussed in the previous section, the ability of firms to charge monopoly level prices is constrained by their inability to meet to discuss differences in preferred prices and to put into place mechanisms to compensate those firms that would lose market share at a higher price.[61] Such an agreement could make a firm like Liggett prefer a much higher industry price than it does today, loosening or removing a significant constraint on more effective coordination. In this way, antitrust immunity might allow the participating firms to agree to choose prices to maximize their total profits and then to allocate these profits in a manner that makes the agreement on prices acceptable even to the mavericks.

3. **Advertising and Marketing Restrictions.** The settlement includes a variety of advertising and marketing restrictions that are intended to reduce sales, especially to youth. These restrictions may also lead to reduced expenditures on advertising and other marketing activities, reducing industry costs and prices accordingly (Title I.A, pp. 8-11). The magnitude of these effects will depend in part upon the extent to which firms substitute toward the permitted non-price modes of marketing competition (such as direct mail advertising to smokers). In the

[60] The ramifications of the proposed antitrust immunity are addressed in greater depth in an Appendix to this Report.

[61] Compensation could take many forms, such as one firm making annual payments on behalf of another firm.

opposite direction, the settlement would restrict advertising that can help new entrants or maverick firms with new products, lower priced products, or new brands to gain market share from the other firms in the market. As a result, restrictions on advertising could reduce competition in the industry and thus lead to higher prices.

4. **Non-Participating Companies Could Face Added Costs.** Firms not signing the settlement (including Liggett and potential entrants not currently in the U.S. market) would be bound by the legislated regulatory rules envisioned by the agreement but not the other voluntary aspects of the agreement (Title III.C, p. 28). Thus, for instance, these firms would not receive the civil liability protections of the settlement. Similarly, wholesalers and retailers dealing with those firms would not receive protection.

Moreover, the legislation envisioned by the settlement would require the non-participating firms to pay higher annual payments than would be required if they had joined the agreement.[62] These payments would be made into an escrow account and could be reclaimed, with interest, 35 years later if not paid out in liability payments. Due to the difficulty of predicting the amount of future liability payments and the long delay before any money could be reclaimed, these payments are likely to be viewed as non-refundable costs of doing business. Thus, from the year 2002 onward, non-participating firms would have a cost disadvantage of nearly 23.5 cents per pack (half of the 47 cent implicit "excise tax") relative to participating firms.[63]

These provisions have the potential to raise the marginal costs borne by Liggett, which now appears to help constrain industry pricing. They may also discourage entry, another factor increasing the likelihood that the industry will move closer to a monopoly pricing level after the settlement. In addition, the provisions may force many of the current small firms out of business, eliminating the possibility that they could expand enough to affect pricing decisions by the major manufacturers.

5. **R&D Incentives.** The settlement requires that any safer cigarette technology developed by a firm in the agreement must be cross-licensed to all other firms in the industry at

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[62] The settlement specifies that a non-participating firm will pay an amount equal to 150 percent of its share of annual payments had it participated, other than the portion allocated to public health programs and law enforcement. The settlement does not discuss the terms under which non-participants might later join the agreement. If such membership is not limited, and if it entails no lump-sum up-front payments, then concerns about anticompetitive effects on non-participating firms would be mitigated because they would have the option of joining the agreement on non-discriminatory terms.

[63] This cost disadvantage would be nearly 31 cents if the excise tax credit discussed above is rescinded.

"reasonable" prices (Title I.E, pp. 14-15). This provision reduces each firm's incentive to develop safer cigarettes, since such R&D becomes less profitable to the firm, and thus helps to discourage the emergence of additional rivalry from a firm with a new product that is attractive to smokers.

In sum, all of these settlement terms, particularly the broad antitrust exemption, have the potential to increase the ability of the major industry members to coordinate their behavior so as to raise prices. The settlement terms also tend to discourage entry and innovation, including the development of alternative products. The resulting competitive effects on the cigarette market could be substantial, because inelastic demand characterizes the adult market. Thus, even small changes in competitive conditions could have sizeable effects on consumer prices and industry profits.

B. The Pass-Through of Tax Increases to Prices

This section reviews the historical evidence on how the cigarette industry has responded to increased taxes. As examined below, research shows that the industry has commonly, in effect, "passed through" to consumers 100 percent or more of tax increases by raising prices. If, as suggested above, the terms of the agreement make coordination on the remaining dimensions of competition somewhat easier, then prices following the tobacco settlement could increase by even more than would be predicted by applying historical pass-through rates.

Pass-through rates are influenced by demand and supply conditions in an industry and by the extent of rivalry among industry members. Standard economic models of firm behavior predict that the pass-through rate in competitive markets will be no more than 100 percent, with the magnitude of the price increase depending upon supply and demand conditions.[64] Pass-through rates in monopolistic industries can be more or less than 100 percent, again depending on supply and demand conditions.[65]

Several empirical studies have found pass-through rates of 100 percent or greater in the cigarette industry. Barnett, Keeler, and Hu estimate a pass-through rate from federal taxes to

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[64] The more elastic the supply and less elastic the demand, the greater the extent to which a tax increase will be borne by consumers in a competitive market. The limiting situation in which all the tax is shifted to consumers (100 percent pass-through) occurs in the case of either perfectly inelastic demand or perfectly elastic supply. See J. Stiglitz, The Economics of the Public Sector 346-67 (1986).

[65] Id. at 359; J. Bulow and P. Pfleiderer, A Note on the Effect of Cost Changes on Prices, 91 J. Pol. Econ. 182-185 (1983).

retail prices of about 102 percent over the 1955 to 1990 period.[66] Harris finds that the 1983 increase of eight cents in the federal excise tax on cigarettes led to a rise of sixteen cents in the retail price.[67]

Analyses of state tax increases also find pass-through rates of 100 percent or more.[68] Using this approach, Sung et al. estimate a pass-through rate for state excise taxes of approximately 127 percent based on their analysis of 11 Western states for the 1967-90 period.[69] Similarly, examining differences in taxes and prices for the 1954-78 period for 50 states, Sumner reports pass-through rates ranging from 103 to 107 percent.[70] Using a later data set that included most states, Merriman estimates a pass-through rate of 106 percent.[71]

This literature on the pass-through of cigarette excise taxes examines the effect of a tax on retail prices regardless of the level in the distribution chain where the tax is legally imposed. The gains or losses from a pass-through different from 100 percent will accrue entirely to the

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[66] P. Barnett et al., Oligopoly Structure and the Incidence of Cigarette Excise Taxes, 57 J. Public Econ. 457-470 (1995).

[67] J. Harris, The 1983 Increase in the Federal Cigarette Excise Tax, in L. Summers, Ed., 1 Tax Policy and the Economy 87-111 (1987). Becker, Grossman, and Murphy suggest that a greater than 100 percent tax pass-through is consistent with their model: if smokers are addicted but take into account the future consequences of their current actions, then firms are induced to further increase prices now because of the tax's deflation of future demand. See G. Becker et al., supra note 18, at 413.

[68] Barnett, Keeler, and Hu, supra note 67, take a skeptical view of the literature focusing on state pass-through experiences, arguing that those studies are measuring pass-throughs by distributors rather than manufacturers because arbitrage prevents manufacturers from charging different wholesale prices in different states. Under such circumstances, an excise tax increase in a single state would not be expected to have much effect on the wholesale price, but simultaneous changes in excise taxes in many states would raise manufacturers' distribution costs, and these increases would be treated no differently than an increase in input costs by the manufacturing sector in determining the retail price.

[69] H. Sung et al., Cigarette Taxation and Demand: An Empirical Model, 12 Contemp. Econ. Pol. 91-100 (1994).

[70] D. Sumner, A Measurement of Monopoly Behavior: An Application to the Cigarette Industry, 89 J. Pol. Econ. 1010-19 (1981).

[71] D. Merriman, Do Cigarette Excise Tax Rates Maximize Revenue?, 32 Econ. Inquiry 419-428 (1994). In both the Sumner and Merriman studies, the estimated pass-through rates are statistically above one.

manufacturing sector, so long as the wholesale and retail distribution of cigarettes is competitive, with distributors obtaining no more than a competitive rate of return for providing their services.[72]

The above evidence suggests that the cigarette companies are likely to raise prices by an amount equal to 100 percent or more of the implicit excise tax imposed by the settlement. Therefore, the examples in the next section assume as a lower bound baseline that prices will increase by an amount equal to the implicit excise tax imposed by the settlement.[73]

As explained in the beginning of this section, the settlement will have various effects on competition in the cigarette industry that may result in substantial price increases beyond those that can be accounted for by changes in costs. For example, suppose that prices rise by 60 cents per pack due to the pass-through of costs, and that prices rise by an additional 60 cents per pack due to the enhanced coordination among industry members. Then prices will increase by $1.20 in total, or 200 percent of the per-pack cost increase. In the next section, this possibility will be described as a "price-increase ratio" of 200 percent. For purposes of the illustrative examples, this ratio of 200 percent will be employed as an upper bound. Even this upper bound scenario would probably leave prices significantly below the monopoly price level.[74]

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[72] In maximizing profits, manufacturers seek an efficient distribution system that passes forward to consumers no more costs than are necessary to obtain competitive distribution services. Any excess price passed through to the ultimate consumer only reduces potential manufacturer profits. Prior to the settlement, the cigarette producers, wholesalers, and retailers would have reached agreements on reimbursement terms that were acceptable to all parties and that provided a competitive return to the distributors. Only if the settlement raised the costs of wholesaling or retailing would one expect distributors to be able to increase the increments they receive for providing distribution services. The settlement does not, however, appear to raise distribution costs in any significant way. Without observing alterations in payments along the vertical chain that occur in reaction to excise tax increases (e.g., changes in promotional allowances, payments for shelving, wholesale price variations, etc.), it is impossible to verify empirically which level in the vertical chain retains any additional revenue associated with a tax change. The literature indicates that after a tax increase, retail prices may rise somewhat more than the tax. Because the wholesale and retail distribution sectors are competitive, any revenue increases that accrue after a tax increase must benefit the manufacturing sector, where, as discussed in section I, a fully competitive outcome is less likely.

[73] The baseline example also assumes a 100 percent pass-through of the excise tax that will be assessed beginning in the year 2000. In addition, the example assumes a 100 percent pass-through of cost savings due to anticipated reductions in advertising and legal costs.

[74] Under the 200 percent price-cost ratio assumption, prices rise to about $3.04 per pack.

(continued...)

III. Examples of the Effect of the Settlement on Prices, Profits, and Public Sector Revenues

This section presents hypothetical numerical examples illustrating the potential financial effects of the proposed settlement. The discussion highlights the potential effects of differing degrees of industry coordination on cigarette prices, cigarette manufacturing industry operating profits, and public sector revenues. The baseline scenario assumes that the cigarette industry cannot exercise more market power as a result of the settlement, and therefore that the industry will "pass through" to cigarette consumers the costs of the settlement at the approximate historical rate of 100 percent, without any additional price increase due to enhanced coordination. Such a situation will be said to exhibit a price-increase ratio of 100 percent. To evaluate the impact of the increased industry coordination, which may be facilitated by the terms of the settlement, the baseline scenario is modified by raising the price-increase ratio from 100 percent to the higher levels of 125 percent and 200 percent.[75]

This comparison demonstrates that increased industry coordination could add to cigarette industry profits and to a lesser extent to public sector revenues. If coordination is improved only moderately, as modeled by an increase in the price-increase ratio from 100 percent to 125 percent, the present value of industry operating profits net of income tax over the first twenty-five years of the settlement potentially rises by about $16 billion (in present value) and public sector revenues (mainly tax revenues) increase by nearly $7 billion (in present value) relative to what these sectors might receive absent features of the settlement making coordination more effective. A substantial increase in the effectiveness of industry coordination, modeled by an increase in the price-increase ratio to 200 percent, could raise industry operating profits by about $56 billion (in present value) and public sector revenues by around $33 billion (in present value). In general, these calculations suggest that roughly two-thirds of the benefits of improved cigarette industry coordination would go to the firms.

The examples also show that regardless of the extent to which industry coordination increases, the cigarette industry and the public sector could benefit financially from the proposed settlement. The financial implications of the settlement for the cigarette industry depend upon the value of those features of the settlement calculated to limit civil liability in lawsuits, and also

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[74](...continued)
Current prices in some European countries are substantially higher than this figure. Based on 1995 data, Harris estimates that the monopoly price for cigarettes in the U.S. is approximately $4.08 per pack. See J. Harris, supra note 34, at 292-294.

[75] A price-increase ratio of 125 percent corresponds to a long-term increase in the price of cigarettes of about 14 cents in addition to increases accounted for by the pass-through of costs. A price-increase ratio of 200 percent corresponds to a similar long-term price increase of 57 cents.

upon the direct effect of the provisions of the settlement on industry profits. In the baseline scenario, the cigarette manufacturers effectively purchase the liability limitations in the settlement for roughly $10 billion (in present value) in lost operating profits. Unless the liability limitations are worth less than $10 billion to the industry, which is unlikely, the manufacturers would benefit financially on balance in the baseline case with the 100 percent price-increase ratio. Moreover, if coordination is enhanced substantially, as modeled by a price-increase ratio of 200 percent, the cigarette industry gains both the civil liability limitations and a potential increase in operating profits of $56 billion in present value relative to the settlement with a 100 percent price-increase ratio. Public sector revenues, including existing taxes as well as the new payments proposed by the settlement, increase in present value by roughly $100 billion in the baseline scenario and an additional $33 billion in present value if enhanced coordination generates a price-increase ratio of 200 percent. Although these amounts are substantial, they are considerably less than the $368.5 billion "face value" of the settlement's annual payments package.[76]

The examples presented in this section are not intended to provide precise predictions of the absolute levels of future prices, sales, profits, or public sector revenues. Their purpose is instead to illustrate the potential incremental effects of the settlement that are likely to depend on (1) any change in the level of competition in the industry as a result of the settlement, and (2) the consumer responsiveness to price increases. The examples provide a rough guide to the possible magnitudes of the financial flows that could be generated by the settlement. The remainder of this section details the basis for the conclusions set forth above.

A. Description of the Baseline Scenario and the Calculation Method

The example illustrates the effect of the settlement in a baseline scenario that uses data on current prices, quantity, taxes and industry costs. The baseline scenario also incorporates estimates of the demand elasticity, the secular downward trend in demand,[77] the price-increase ratio, and the settlement-induced marketing and legal cost savings. The key assumption in the baseline scenario is that the price-increase ratio is 100 percent, reflecting the historical pass-through rate but not presuming improved industry coordination. Each assumption used in the baseline scenario is presented in Table 8.

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[76] Public sector revenues from the settlement will not reach the "face value" levels due to reductions in cigarette unit sales as prices rise and the continuation of the current U.S. trend toward reduced smoking. In addition, adjusting for the fact that the payments are made over a long time period rather than up front by discounting the future payments results in a lower present value of the settlement.

[77] The pattern of demand for cigarettes in the U.S. has shown a steady downward time trend that is unrelated to price changes. This trend is referred to as the secular trend in cigarette demand.

To facilitate the analysis, the example views the volume-adjusted portion of the annual payment as the equivalent of a per-pack excise tax, and assumes that the per-pack amount will be passed through to consumers in the form of higher prices.[78] It also assumes that the profit-penalty portion of the annual payment and the initial "up-front commitment" of $10 billion is not passed through in higher prices.

In the example, the price-increase ratio relates the increase in price from the baseline price to all net cost changes under the settlement. Therefore, price changes also reflect the settlement-induced advertising and legal cost savings, assumed to be five cents per pack.[79]

The quantity of cigarettes sold in each year is calculated by adjusting the 1997 quantity for the secular downward trend in demand, assumed to be -0.6 percent per year,[80] and for the quantity effect arising from the price increases caused by the settlement. The quantity effect arising from the price increase is calculated using the appropriate constant elasticity demand

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[78] As discussed in section II.A.1, the annual payment amount is determined by first proportionally adjusting the "face value" amount specified in the settlement by any changes in sales volume that have occurred since the base year of the settlement. If volume adjustment reduces the amount of the payment, the reduction will be reduced by 25 percent of any additional operating profits the industry earns in that year as compared to the base year. This latter adjustment is referred to here as the "profit penalty." The volume-adjusted portion of the annual payment can be viewed as the equivalent of a constant per-pack excise tax because the proportional adjustment will lower the total amount of the payment but will always result in same per-pack amount, as in an excise tax.

[79] Cigarette industry advertising expenditures in media such as magazines, newspapers, billboards, and point of sale promotion totals about $1.5 to $2 billion a year, or about 6 to 8 cents per pack of cigarettes sold. The industry also spends another $3 to $3.5 billion per year in cents-off coupons and other promotional expenditures that would not be directly restricted by the settlement. See FTC Report to Congress for 1995 Pursuant to the Federal Cigarette Labeling and Advertising Act. The industry will likely reduce overall advertising expenditures under the settlement but continue some advertising in permitted media such as direct mail, adult-only magazines, and point of sale promotion in adult-only establishments. Cigarette industry legal costs appear to be around 2.5 cents a pack. The assumption of a five cent per pack reduction in advertising and legal costs is consistent with a reduction of 50 percent to 60 percent in those cost categories. No reduction is assumed in the other cents-off coupons or other promotional categories.

[80] J. Harris, supra note 56, at 5.

function, which in the baseline scenario is assumed to have a constant price elasticity equal to -0.4.[81] Total sales revenues are then calculated by multiplying the price and quantity figures.

The industry's operating profits in the baseline scenario are calculated by multiplying the estimated average profit margin times current quantity and subtracting the volume-adjusted amount of the annual payment.[82] Operating profits before income tax are calculated by subtracting from operating profits the "up-front commitment" paid at the start of the settlement and any annual payment profit penalties. Operating profits net of income tax are calculated by subtracting corporate income taxes,[83] which are calculated by multiplying pre-tax operating profits by the current marginal corporate income tax rate of 35 percent. The calculations of industry profits do not include estimates of the value of the limitations on civil liability, although this likely constitutes a major component of the financial benefits of the settlement to the industry.[84]

Federal and state excise tax revenues are calculated by multiplying the pre-existing excise tax rates by the quantity of cigarettes sold in each year. Settlement payments are the sum of the initial "up-front commitment" payment and the annual payment, including any adjustments of the annual payment for volume changes and excess profits. Public sector revenues are from federal and state excise taxes, settlement payments, and corporate income tax revenue. Corporate income tax revenues are calculated by multiplying pre-tax operating profits by the corporate income tax rate. And finally, present value calculations use a discount rate of 7 percent.[85]

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[81] The consequences of alternative assumptions about the functional form of industry demand are considered in Section III. D below.

[82] The profit levels are approximations at best and are used mainly to examine the potential incremental profits arising from an increase in the ability of the industry to coordinate pricing due to certain features of the settlement.

[83] The calculation assumes that payments under the settlement are tax-deductible.

[84] One Wall Street research firm has estimated that the value of a comprehensive tobacco settlement to Philip Morris is on the order of $75 to $100 billion. G. Black and J. Rooney, Tobacco: As Third Wave Draws to a Close, Revaluations Likely to Mirror 1987 4 (Bernstein Research, Aug. 6, 1997). Considering that Philip Morris is close to half of the cigarette industry, the liability reduction due to the settlement might be worth as much as $150 to $200 billion to the industry prior to consideration of any anticompetitive gains due to enhanced industry coordination fostered by the settlement.

[85] The Office of Management and Budget recommends a 7 percent real discount rate for present value calculations involving government programs. See Office of Management and Budget, Economic Analysis of Federal Regulations Under Executive Order 12866 9 (Jan. 11,

(continued...)

B. Prices, Industry Profits, and Public Sector Revenues in the Baseline Scenario

Table 9 presents the figures obtained for prices, quantities, sales revenues, and manufacturer domestic operating profits in the baseline scenario. Table 10 presents the figures obtained for public sector revenues. In both Tables 9 and 10, the main comparison presented for each quantity is what it would be without and with the proposed settlement. In each "without settlement" case, the example assumes that the existing state and federal excise taxes (including the recently passed federal excise tax) are in effect. In each "with settlement" case, the example assumes that there are, in addition, the excise taxes needed to collect the settlement revenue and that the recently enacted excise tax credit is in effect.[86] All dollar figures are in 1997 dollars.

In the year 2002 in the baseline scenario (see Table 9), the year in which the annual payment reaches its full face value amount, the price with the settlement will be forty-two cents above what the price would be in 2002 without the settlement. The higher prices reflect the settlement costs passed through to consumers in the form of price increases at the baseline price-increase ratio of 100 percent.[87] Retail sales revenues increase by $5.5 billion, reflecting the inelasticity of demand. Before accounting for the value of civil liability limitations provided by the settlement, Table 9 shows that industry pre-tax operating profits decrease by $0.5 billion and operating profits net of income tax decrease by $0.3 billion. Table 10 shows public sector excise tax revenues decreasing by $1.2 billion in the year 2002, reflecting the lower quantity of cigarettes sold. Combined excise tax and settlement payments increase by $8.8 billion, reflecting the addition of the settlement payments. The public sector's total gain from the settlement in 2002, including excise taxes, settlement payments, and corporate income tax revenues, is approximately $8.6 billion.[88]

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[85](...continued)
1996).

[86] Under the Balanced Budget Act of 1997, Pub. L. No. 105-33, 111 Stat. 251 (1997), Federal excise taxes on cigarettes will rise 10 cents in the year 2000 and 5 cents more in 2002. Section 9302 of Pub. L. No. 105-33 provides that excise taxes collected under that law will be credited against payments to be made under Federal implementation of the tobacco industry settlement agreement of June 20, 1997.

[87] The forty-two cent price increase is less than the often cited sixty-two cent increase due to the existence of the recently passed settlement credit and the assumed advertising cost savings. In 2002, under the 100 percent pass-through assumption, the without settlement price per pack would be equal to $1.90 + $0.15 = $2.05. The with settlement price would be increased by the $0.62 settlement excise tax and reduced by the $0.15 credit and the $0.05 savings on advertising and legal expenses, resulting in a price of $2.47. Therefore, the price difference would be $0.42.

[88] Corporate income taxes fall significantly in the first year of the settlement due to the initial
(continued...)

Table 9 also shows that in the baseline scenario, exclusive of the effect of the civil liability limitation, the sum of industry operating profits net of income tax over the first 25 years of the settlement is $14.5 billion lower than it would be without the settlement, and that the discounted present value of operating profits net of income tax is $10.2 billion lower over this period under the settlement.

Table 10 shows that public sector revenues solely from the settlement's "up-front commitment" and annual payments total $241.8 billion over the first 25 years and have a discounted present value of $118.1 billion in the baseline scenario. This is in contrast to the $368.5 billion "face value" sum stated in the settlement. The sum of the settlement payments is reduced below the face value because of the decrease in smoking associated with the secular decline in cigarette demand and by the reduction in consumption that occurs due to the higher prices.

Table 10 also shows that under the baseline scenario the discounted present value of the sum of excise tax and settlement payments collected over the first 25 years is $105.9 billion higher in the baseline scenario than the present value of the excise taxes that would be collected over this period in the absence of the settlement. With the settlement, the sum of excise tax revenues, settlement payments, and corporate income tax revenues is $207.3 billion ($100.4 billion in present value) higher than without the settlement. [89, 90]

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[88](...continued)
payment. After the initial year of the settlement, corporate income tax revenues fall slightly in the 100 percent price-increase ratio case because corporate profits decline modestly as consumers purchase fewer cigarettes at the new, higher prices.

[89] The increase in overall public sector revenues is smaller than the settlement payment figures noted in the preceding paragraph because the settlement payments (and the increased corporate income tax revenues) are partially offset by the decrease in excise tax revenues.

[90] If the law crediting the ten to fifteen cent per pack excise tax passed in August 1997 against the settlement payments is rescinded, the implicit settlement-related excise tax will increase by the amount of this credit. If, as in the baseline scenario, this increase is passed on to consumers, it will have little effect on industry operating profits but will increase public sector revenues. The resulting higher price of cigarettes would be expected to further reduce cigarette consumption.

C. The Effect of Increased Industry Coordination

As discussed earlier, the less-than-fully-competitive nature of the cigarette industry, the features of the settlement that may make industry coordination more effective, and the relatively inelastic demand for cigarettes may allow the industry to increase prices far in excess of the increased costs arising from the settlement. The effect of increased industry coordination on industry profits and public sector revenues can be illustrated by altering key assumptions and comparing the resulting scenarios to the baseline. It is not unreasonable to think that certain terms in the settlement, particularly the broad antitrust exemption, might make it easier for the cigarette producers to achieve a consensus on industry price and other dimensions of competition. Such enhanced coordination that might occur as a result of the settlement is captured in the examples as an increase in the price-increase ratio.

In the baseline scenario it is assumed that price increases by 100 percent of the volume-adjusted portion of the settlement payment. A price-increase ratio of 125 percent would represent somewhat more effective coordination. A price-increase ratio of 200 percent would represent substantially greater coordination, though still less than monopoly pricing. Table 11 presents the results of the example when figures of 100 percent, 125 percent, and 200 percent are alternatively used for the price-increase ratio.[91] The baseline price-increase ratio of 100 percent corresponds to a price increase (after 5 years) of $0.42 per pack to consumers from the baseline price of $2.05. A price-increase ratio of 125 percent corresponds to a price increase of $0.56 per pack and a price-increase ratio of 200 percent corresponds to a price increase of $0.99.[92]

The results in Table 11 examine the effect, under the settlement, of industry coordination under a variety of assumptions about the elasticity of demand and the secular annual decline rate of cigarette sales.[93] The results show that increasing coordination has a dramatic impact on

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[91] As noted in Section II, estimates of the monopoly price for cigarettes calculated by Harris imply that the pass-through rate could extend beyond the 200 percent level. See J. Harris, supra note 34, at 292-294.

[92] With the 100 percent price-increase ratio, the full $0.57 cost increase (the $0.62 minus the $.05 savings in advertising and legal costs) is added to the base price of $1.90, bringing it to $2.47. With the 200 percent price-increase ratio, double the $0.57 (= $1.14) is added to the base price of $1.90, bringing it to $3.04. In both cases the new price is compared to the without-settlement price of $2.05. Thus the change is price under the 100 percent is $0.42 (= $2.47 - $2.05) and under the 200 percent is $0.99 (= $3.04 - 2.05).

[93] An elasticity of demand of -0.2 represents a smaller consumer response to changes in cigarette prices than does the scenario presented in Tables 9 and 10, implying that the quantity of cigarettes sold would not fall as much as in the original baseline scenario. Conversely, an (continued...)

industry profits, for each demand elasticity assumption. Using the assumptions in the baseline scenario, where the price-increase ratio is 100 percent, the sum of industry operating profits net of income tax over the first 25 years of the settlement would total $49 billion in present value terms. If the price-increase ratio is 125 percent, the sum of operating profits net of income tax over this period would total $65 billion in present value. And if the price-increase ratio is 200 percent -- a figure suggestive of what could happen if the industry is given a broad antitrust exemption -- the present value of the sum of operating profits net of income tax over this period could total $105 billion, or roughly $56 billion more than what the industry obtains in the baseline scenario.[94] These potential gains to the industry represent a market power premium that could accrue if the settlement leads to an enhanced ability to coordinate behavior among the firms.

This same pattern of results holds for the various assumptions about the elasticity of demand and the secular rate of decline in cigarette sales. Under all of the scenarios, industry profits under the settlement increase substantially if the industry is able to increase the price-increase ratio from the base level of 100 percent to the higher, and more uncertain, level of 200 percent. For example, as shown in Table 11, with a 100 percent price-increase ratio and a -0.2 elasticity level, the present value of industry operating profits net of income tax is $51 billion compared to $117 billion if the price-increase ratio is 200 percent. At the much larger elasticity of -0.8, the corresponding values are $44 billion and $90 billion. In both cases the change in profits net of income tax due to the change in price-increase ratio is substantial.

Changes in the price-increase ratio have a much smaller effect on public sector revenues. When consumer demand is inelastic, more effective industry coordination generally increases public sector revenues, because revenues from corporate income taxes and the profit-penalty portion of the annual payment increase as industry profits increase, and the inelastic consumer demand limits the quantity decrease and the resulting negative impact on excise tax revenues. In the baseline scenario, which uses the price-increase ratio of 100 percent, overall public sector revenues from the cigarette industry total a present value of $322 billion over the first 25 years of the settlement. If the price-increase ratio is changed to 200 percent, public sector revenues would increase to $355 billion in present value. The potential increase in public sector revenues resulting from the higher price-increase ratio is even larger when demand is more inelastic.[95]

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[93](...continued)
elasticity of demand of -0.8 represents a greater consumer response to changes in prices, which would result in a larger fall in quantity.

[94] As with all the industry profit figures discussed in this section, these profits would accrue mainly to the major cigarette companies, the firms with significant market shares.

[95] In contrast, when demand is more elastic, the consumer response to the price increase is
(continued...)

Table 12 illustrates how the increased revenue from improved industry coordination would be shared between the public sector and the tobacco industry under the proposed settlement. When increased industry coordination occurs, industry profits rise because prices rise and demand does not fall off enough to offset the price rise. Public sector revenues tend to rise because, under the assumed corporate income tax, the manufacturers pay 35 percent of their increased profits to the public sector. However, the increase in income tax revenues is offset somewhat by a reduction in revenues from excise taxes as the quantity demanded falls.

As the entries in Table 12 show, in the illustrative calculations the industry receives approximately two-thirds of the gains from the increases in industry coordination. These incremental gains represent a market power premium received by the industry due to the enhanced ability to coordinate. As the price-increase ratio changes from 100 percent to 125 percent, the industry could receive a present value of $16 billion (or 70 percent) of the total of $23 billion of additional surplus generated by the enhanced industry coordination.[96] And, the industry could receive a present value of $56 billion (or 63 percent) of the $89 billion in additional surplus generated by increasing the price-increase ratio from 100 percent to the more uncertain level of 200 percent. In the examples, the public sector receives approximately one-third of the total surplus generated by increasing the price-increase ratios.

These results suggest that industry coordination is not likely to have a large negative impact on public sector revenues and may even lead to increased revenues. The main effect of more effective coordination, however, is to increase cigarette prices and industry profits. Industry operating profits may increase substantially above pre-settlement levels if the settlement enables the industry to coordinate more effectively. The additional profits would be obtained primarily at the expense of smokers, whose inelastic demand for cigarettes allows the industry to increase prices substantially while causing only a proportionally smaller effect on sales. Also, these additional profits are separate and apart from whatever value the firms might gain from civil liability limitations.

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[95](...continued)
larger and the resulting larger drop in quantity causes a larger drop in excise tax revenues, offsetting the income tax and profit-penalty gains and causing the higher price-increase ratio to generate a small decrease in public sector revenues. In all cases involving a change from a 100 percent to a 200 percent price-increase ratio, corporate income tax revenues rise because the government obtains a 35 percent share of the higher profits obtained by the firms as price increases much more than the cost of the excise tax increase.

[96] In this context, the term "surplus" refers to the total of excise tax revenues, settlement payments, income tax revenues, and manufacturers' operating profits net of income tax related to cigarette sales. The dollar amounts presented in Table 12 are the present discounted values of the 25-year streams of payments.

D. Issues Not Addressed in the Examples

A number of factors have not been explicitly incorporated into the example in order to simplify the analysis. These factors and their potential effect on the results are discussed here. While the example does not explicitly include all of the complexities discussed in this section, many of the issues are captured within the parameters of the sensitivity analysis, which varies the assumptions about the elasticity of demand and the secular decline in cigarette sales used in the example. Furthermore, as noted earlier, the example is not intended to provide precise predictions of the absolute levels of future prices, sales, profits, or public sector revenues, but rather mainly illustrates the potential incremental effect of the settlement and how that incremental effect depends upon the ability of the industry to coordinate effectively and the consumer demand response to price increases.

The example uses a constant elasticity of demand to estimate the demand effect of price increases. In alternative specifications of demand such as a linear demand curve, the elasticity will rise as price rises, implying that the reduction in quantity will be larger than that predicted under a constant elasticity assumption and that sales revenues, industry profits, and public sector revenues will be lower.[97] The possible effect of a changing elasticity is largely captured in the sensitivity analysis presented in the top half of Table 11, which varies the elasticity assumption from a low of -0.2 to a high of -0.8. For example, if the demand elasticity rises from -0.4 to -0.8 at the same time the price-increase ratio increases from 100 percent to 200 percent -- that is, if demand grows more elastic as price rises -- then, according to Table 11, the present value of industry operating profits net of income tax rises by $41 billion (rather than $56 billion in the constant elasticity case)[98] and public sector revenues decline by $22 billion (rather than rising by $33 billion). Thus, under this alternative assumption about demand, only the industry benefits from more effective coordination; the public sector loses. These alternative specifications of demand may not, however, be appropriate for the cigarette industry, because in this industry it is possible that the demand elasticity will fall as price rises, as a higher price forces casual smokers with elastic demand out of the market and leaves only committed smokers with inelastic demand.[99] In this case, quantity will fall by a smaller amount than predicted under a constant

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[97] Another alternative specification of demand, a semi-log curve, also has the property that elasticity rises as price rises.

[98] This can be seen by comparing the change in the present values of industry operating profits net of income tax for the constant elasticity base case of -0.4 with the change in the present values moving from the base case to the larger elasticity of -0.8 ($90 billion minus $49 billion).

[99] G. Becker et al., supra note 18, at 412-413. Moreover, the international evidence is consistent with the assumption of constant elasticity. See M. Stewart, The Effect on Tobacco Consumption of Advertising Bans in OECD Countries, 12 Int'l J. Advertising 164 (1993).

elasticity assumption, and sales revenues, industry profits, and public sector revenues will be higher.

The example also applies the same elasticity of demand to all smokers. Some studies have suggested that teenage smokers have a higher elasticity of demand than adult smokers, reflecting the fact that they are not yet as "hooked" as long-time smokers and that they have a much tighter income constraint on their expenditures.[100] A higher elasticity would imply that the price increases caused by the settlement will lead to proportionally larger decreases in demand in the youth market than in the adult market. The youth access restrictions required by the settlement also may contribute to a larger impact on the youth market. While both of these factors are important in any analysis of the effect of the settlement on youth smoking, they do not have much of an effect on the overall sales, profits, and public sector revenue figures calculated in the example. Youth smoking has been estimated to account for only about 2.1 percent of total cigarette sales.[101] Even a relatively large reduction in demand in the youth market would thus have only a minor effect on overall market demand, at least in the short term.

The impact of any reduction in youth smoking would have a larger impact on overall market demand in the long term, however, because fewer youth smokers would grow into adult smokers. If the settlement substantially reduces youth smoking, which in turn substantially reduces adult smoking in the future, then the long-term demand-reduction effect of the settlement would be larger than indicated in the example, and long-term sales revenues, industry profits, and public sector revenues would be lower.[102]

The example also does not explicitly account for the potential reduction in demand caused by the advertising restrictions specified in the settlement. Any effect of the advertising restrictions is likely to be larger in the long term rather than short term. The biggest potential impact may be in the youth market of the future, where children may go through their teen and pre-teen years without seeing the number and variety of advertisements for cigarettes that exist today. The potential effect of the advertising restrictions is likely to be less on the current youth market because current teens have already been exposed to years of cigarette ads. The restrictions are also less likely to have a significant effect on adult smokers, who have already formed the smoking habit. An effect of advertising restrictions on the future youth market might be similar to the possible impact of higher prices and access restrictions on youth smoking noted

[100] See, for example, F. Chaloupka and M. Grossman, supra note 14.

[101] J. Harris, supra note 56, at 4.

[102] If future industry sales and profits drop far enough, public sector revenues could actually fall below pre-settlement levels, because excise and corporate income tax revenues would fall and would not be offset by settlement payments, which could be substantially reduced due to the volume decrease.

above. With such an effect, the settlement likely would cause a larger decrease in cigarette sales than estimated in the example, and sales revenues, industry profits, and public sector revenues would be lower. The intended effects of the advertising restrictions on aggregate youth smoking are suggested by the sensitivity analysis presented in the bottom half of Table 11, which assumes a faster secular decline in demand with the settlement than in the baseline case.[103]

The example uses a 7 percent discount rate to calculate the present values of the 25-year streams of payments and revenues. This rate is used by the Office of Management and Budget in evaluating federal projects. If 4 percent, the approximate real interest rate for long-term U.S. Treasury bonds,[104] is used instead of the 7 percent used in the example, the present values of the profit and public sector revenues would be approximately one-third greater than reported in Tables 10-12. Specifically, under a 4 percent discount rate, the present value of the industry's operating profits net of income tax in the baseline scenario would be $65.4 billion rather than the $48.9 billion shown in Table 9, and the present value of the public sector's excise tax plus settlement payments plus income tax revenue would be $423.6 billion rather than the $322.0 shown in Table 10. The pattern of amounts and changes in Tables 10-12 would otherwise be unchanged.

Another factor not included in the example is the possibility that the excise tax credit may be removed. As noted earlier, the U.S. Senate and House of Representatives both recently approved legislation that would eliminate the credit of the new excise taxes toward settlement payments. Eliminating the credit will increase the volume-adjusted annual payment under the settlement by 15 cents per pack, bringing the per-pack payment back to the original 62 cents provided for in the settlement. In the baseline scenario, the elimination of the credit makes little difference to industry operating profits while adding to industry settlement payments and public sector revenues.[105] More effective coordination continues to benefit both the cigarette industry

[103] The assumption of a 2 percent annual decline in the demand for cigarettes under the settlement is not intended to be an estimate of the likely effect of the settlement's advertising and marketing restrictions, but is used only to illustrate the effect of a larger annual decline in smoking on industry profits and government revenues. The financial effects on firms due to changes in the Food and Drug Administration jurisdiction or regulations or due to reductions in sales due to enhanced public health campaigns are also not included in the calculations provided here, but any negative effects on firm profits from such changes might be suggested by the scenario with the faster secular decline.

[104] A real interest rate is the nominal interest rate adjusted for the estimated rate of price inflation.

[105] Without the credit, industry operating profits net of income taxes over the first twenty-five (continued...)

and the public sector, in about the same amounts as were reported in Table 12b under the prior assumption that the excise tax credit remained in force, with the industry still retaining about two-thirds of the resulting gains.[106]

Several additional factors not incorporated in the example could result in lower public sector revenues. There is a possibility that the higher cigarette prices caused by the settlement payments could lead to a larger black market in cigarettes.[107] The black market may circumvent annual payments and excise taxes and act to reduce public sector revenues.[108] It is also possible that cigarette companies could adopt accounting strategies to reduce book profits, and so limit their payments of the profit-penalty and any increased corporate income taxes. This could also reduce public sector revenues below the levels estimated in the example. In addition, higher cigarette taxes could reduce the demand for other tobacco-related products and services and thereby indirectly affect public sector revenues derived from these related markets.[109]

Public sector revenues also may be reduced by awards in private suits against the industry. While the settlement (if enacted into law) would prohibit class action suits and punitive damage awards in private suits, it allows compensatory damage awards in private suits. The

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[105](...continued)
years of the settlement in the baseline scenario will decrease slightly to $101.8 billion ($48.0 billion in present value), industry settlement payments will increase to $302.5 billion ($143.9 billion in present value), and total public sector revenues will increase to $714.3 billion ($344.2 billion in present value).

[106] If the industry is able to coordinate somewhat more effectively under the settlement (as in the 125 percent price-increase ratio case), industry operating profits net of income taxes will increase to $137.8 billion ($64.1 billion in present value), industry settlement payments will increase to $303.4 billion ($144.8 billion in present value), and total public sector revenues will increase to $727.7 billion ($350.6 billion). If the industry is able to coordinate substantially more effectively (as in the 200 percent price-increase ratio case), industry operating profits net of income taxes will increase to $223.2 billion ($103.3 billion in present value), industry settlement payments will increase to $330.4 billion ($156.9 billion in present value), and total public sector revenues will increase to $782.4 billion ($375.5 billion).

[107] The higher prices could induce the smuggling of cigarettes from foreign countries and the diversion of U.S. produced cigarettes to a black market.

[108] An extensive black market would also lower the price-increase ratio, since it would be the equivalent of additional competitors in the market.

[109] The example also does not take into account any indirect effects of the settlement on overall U.S. economic activity and public sector revenue derived from this activity.

settlement specifies that the annual amount of compensatory damage awards will be limited to 33 percent of that year's annual payment, and that any award payments will reduce that year's annual payment at an 80 percent rate.[110] Thus, any future private suit awards will reduce public sector revenues from the settlement. It is difficult to predict the size of any such effect.

Public sector revenues may be increased by the payment of "look-back" surcharges if youth smoking is not reduced to the target levels specified in the settlement. The surcharges could total up to $2 billion per year, though up to 75 percent of the surcharge could be abated on a company-by-company basis if the FDA determines that the company has engaged in good faith efforts to reduce youth smoking. It is difficult to predict the likely amount of surcharges that will be paid by the industry, which will depend on the future levels of youth smoking and on the abatement decisions of FDA.

Another simplification in the example is that it treats the cigarette market on an aggregated basis rather than breaking down the market into component segments, such as premium brands, discount brands, and generics. If the settlement causes the price differential between premium cigarettes and discount brands to change or if an identical dollar increase affects segment consumption in different ways, however, then the market shares of the component segments could also change. The effect of any such changes on the demand for cigarettes, industry profits, and public sector revenues, would be largely reflected in the example through their effects on the average price of cigarettes.[111]

Finally, while the volume-adjusted face value of the annual payment is passed on to consumers in the form of higher prices, the example treats the profit-penalty portion of the annual payment (should it be implicated in any year) and the $10 billion "up-front commitment" payment as fixed costs that are not passed through to consumers. If these payments were passed through to consumers, industry profits would increase. Public sector revenues would likely increase in the relatively more inelastic demand scenarios and decrease slightly in the more elastic demand scenarios. The increase in industry profits would occur under all assumptions about the price-increase ratio, and industry profits would still increase substantially under more effective coordination.

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[110] The 33 percent limit applies to the combined amount of judgments and settlements. Amounts in excess of the limit are carried over to be paid in the following year, or in the next year below the limit.

[111] For instance, if the market share of generics grew, it would pull down the average price of cigarettes. This effect could be captured in the example by using a slightly lower price-increase ratio, which would result in slightly lower industry profits and public sector revenues. If the settlement led to increased industry coordination, however, the industry might be able to narrow the price gap between the segments and thus avoid growth of generic market share.

While all of the factors discussed in this section add complexity to the analysis, none changes the basic pattern illustrated in Tables 11 and 12 and discussed above -- that increased industry coordination, possibly facilitated by terms of the settlement, could lead to substantially increased profits under the settlement and that any additional surplus resulting from the increased coordination would likely disproportionately benefit industry, not the public sector.

Table 8

Assumptions Used in the Baseline Scenario

1997 Price (per pack)	$1.90
1997 Quantity (billions of packs)	24.2
Current Excise Taxes (per pack):	
Federal	$0.24
State (national average)	$0.32
Advertising and Marketing Costs (per pack)	$0.23
Legal Costs (per pack)	$0.025
Initial Average Profit Margin from Operations (per pack)	$0.32
Corporate Income Tax Rate on Incremental Industry Profits	35%
Present Value Discount Rate	7%
Cost Change Price-increase ratio	100%
Demand Trend Growth Rate	-0.6%
Demand Elasticity	-0.4
Settlement Induced Advertising and Legal Cost Savings (per pack)	$0.05

New Budget Bill Excise Tax (per pack):

Year:	1997	1998	1999	2000	2001	2002+
	---	---	---	0.10	0.10	0.15

Settlement Payments ($billion):

Year:	1997	1998	1999	2000	2001	2002+
Up Front Commitment	10.0	---	---	---	---	---
Annual Payment	---	8.5	9.5	11.5	14.0	15.0
Lookback Surcharge	---	---	---	---	---	0
Private Suit Award Credit	0	0	0	0	0	0
Annual Payment as Excise Tax per Pack ($)	0	.352	.393	.476	.579	.621

New Budget Bill Tax Credit (per pack):

Year:	1997	1998	1999	2000	2001	2002+
	---	---	---	0.10	0.10	0.15

Sources for assumptions: (listed on the following page)

NOTES TO TABLE 8: Sources for Assumptions

1. price:

   Base price of $1.85 per pack comes from Tobacco Institute, The Tax Burden on Tobacco (1996), p. vii. This is the weighted average price of cigarettes for the U.S. as of November 1, 1996. This price was converted to a 1997 estimate by adjusting it by the rate of change in the BLS Tobacco and Smoking Products CPI index for the October 1996-July 1997 period.

2. output:

   Total 1996 cigarette consumption of 24.4 billion packs is based on the USDA estimate. This was then adjusted downward by the assumed 0.6 percent decline rate to get an estimated consumption figure of 24.2 billion packs for 1997.

3. taxes:

   1996 federal and state taxes from Tobacco Institute, The Tax Burden on Tobacco (1996).

4. profit margin:

   Estimate of $0.32 is based on weighted average of operating profits per pack from SEC 10K submissions of Philip Morris, R.J. Reynolds, Loews, and Liggett. The profits figures are based on domestic tobacco operations of the companies.

5. secular decline rate:

   Estimate of assumed rate of decline in cigarette consumption of 0.6 percent from J. Harris, A Working Model for Prediction the Consumption and Revenue Impacts of Large Increases in the U.S. Federal Cigarette Excise Tax, (July 1, 1994)(unpublished manuscript).

6. advertising and promotion costs:

   Unpublished estimate from FTC, based on various FTC reports to Congress pursuant to the Federal Cigarette Labeling and Advertising Act.

Table 9

Prices, Quantities, Sales Revenues, and Profits in the Baseline Scenario

	(Year 0) 1997	(Year 1) 1997	(Year 5) 2002	(Year 10) 2007	(Year 25) 2022	Year 0 through 25 Sum	Year 0 through 25 Present Value
Price ($ per pack):							
Without Settlement	1.90	1.90	2.05	2.05	2.05	---	---
With Settlement	1.90	2.20	2.47	2.47	2.47	---	---
Change	0.00	0.30	0.42	0.42	0.42	---	---
Quantity (billions of packs):							
Without Settlement	24.2	24.1	22.8	22.1	20.2	569.3	---
With Settlement	24.2	22.7	21.1	20.5	18.7	531.0	---
Change	0.0	-1.4	-1.6	-1.6	-1.5	-38.4	---
Retail Sales Revenues ($billions):							
Without Settlement	46.0	45.7	46.7	45.3	41.4	1154.0	570.7
With Settlement	46.0	49.9	52.2	50.7	46.3	1282.4	630.4
Change	0.0	4.2	5.5	5.4	4.9	128.4	59.7
Manufacturer Profits, Exclusive of Value of Liability Limitations ($billions):							
Operating Profits Before Income Tax:							
Without Settlement	7.7	7.7	7.3	7.1	6.5	182.2	91.0
With Settlement	-2.3	7.3	6.8	6.6	6.0	159.9	75.2
Change	-10.0	-0.4	-0.5	-0.5	-0.5	-22.3	-15.8
Operating Profits Net of Income Tax:							
Without Settlement	5.0	5.0	4.7	4.6	4.2	118.4	59.1
With Settlement	-1.5	4.7	4.4	4.3	3.9	103.9	48.9
Change	-6.5	-0.3	-0.3	-0.3	-0.3	-14.5	-10.2

Note: All dollar figures are 1997 dollars.

Table 10

Public Sector Revenues in the Baseline Scenario

	(Year 0) 1997	(Year 1) 1997	(Year 5) 2002	(Year 10) 2007	(Year 25) 2022	Year 0 through 25 Sum	Year 0 through 25 Present Value
Federal & State Excise Tax ($billions):							
Without Settlement	13.6	13.5	16.2	15.7	14.3	391.1	189.8
With Settlement	13.6	12.7	15.0	14.6	13.3	364.4	177.6
Change	0.0	-0.8	-1.2	-1.1	-1.0	-26.7	-12.3
Settlement Payments ($billions):							
Without Settlement	0.0	0.0	0.0	0.0	0.0	0.0	0.0
With Settlement	10.0	8.0	9.9	9.6	8.8	241.8	118.1
Change	10.0	8.0	9.9	9.6	8.8	241.8	118.1
Corporate Income Tax ($billions):							
Without Settlement	2.7	2.7	2.6	2.5	2.3	63.8	31.8
With Settlement	-0.8	2.5	2.4	2.3	2.1	56.0	26.3
Change	-3.5	-0.2	-0.2	-0.2	-0.2	-7.8	-5.5
Excise Tax + Settlement Payments ($billions):							
Without Settlement	13.6	13.5	16.2	15.7	14.3	391.1	189.8
With Settlement	23.6	20.7	24.9	24.2	22.1	606.2	295.7
Change	10.0	7.2	8.8	8.5	7.8	215.1	105.9
Excise Tax + Settlement Payments + Income Tax ($billions):							
Without Settlement	16.3	16.2	18.7	18.2	16.6	454.8	221.7
With Settlement	22.8	23.2	27.3	26.5	24.2	662.2	322.0
Change	6.5	7.0	8.6	8.3	7.6	207.3	100.4

Note: All dollar figures are 1997 dollars.

Table 11

The Effect of Increased Industry Coordination on Industry Profits and Public Sector Revenues Under Various Assumptions About Demand Elasticity and Annual Decline Rate of Demand

Scenario Assumptions: Demand Elasticity	Scenario Assumptions: Price-Increase Ratio	Settlement Payments Years 0 through 25 ($billions): Sum	Settlement Payments Years 0 through 25 ($billions): Present Value	The Present Value of Industry Profits and Gov't Revenues Over Years 0 Through 25 ($billions): Industry Operating Profits Net of Income Tax	Public Sector Revenues: Excise Taxes	Public Sector Revenues: Excise Taxes and Settlement Payments	Public Sector Revenues: Excise Tax, Settlement Pmts, and Corporate Income Tax
Secular Annual Rate of Decline in Demand Under the Settlement = 0.6%:							
-0.2	100%	254	124	51	186	309	337
-0.2	125%	263	128	68	184	312	349
-0.2	200%	295	140	117	179	320	383
-0.4	100%	242	118	49	178	296	322
-0.4	125%	245	120	65	174	294	329
-0.4	200%	275	133	105	165	299	355
-0.8	100%	220	108	44	163	271	295
-0.8	125%	213	105	59	156	262	294
-0.8	200%	224	111	90	141	252	300
Secular Annual Rate of Decline in Demand Under the Settlement = 2.0%:							
-0.2	100%	214	109	45	164	274	298
-0.2	125%	216	111	61	163	274	307
-0.2	200%	247	125	102	159	284	339
-0.4	100%	204	105	43	157	262	285
-0.4	125%	202	104	58	154	259	290
-0.4	200%	224	116	93	147	262	312
-0.8	100%	186	96	39	144	240	261
-0.8	125%	178	93	52	139	232	260
-0.8	200%	182	96	80	126	221	264

Notes: (1) Baseline scenario underlined. (2) All dollar figures are 1997 dollars.

Table 12a

Financial Flows Under Four Scenarios
(billions of 1997 dollars)

Scenario	Price-Increase Ratio	Operating Profits Net of Income Tax		Public Sector Revenue	
		Sum	Present Value	Sum	Present Value
Without Settlement	——	118	59	455	222
Settlement Baseline Scenario	100%	104	49	662	322
Settlement With More	125%	140	65	677	329
Effective Coordination	200%	227	105	735	355

Table 12b

Financial Implications of More Effective Coordination
(billions of 1997 dollars)

Comparison of Settlement Scenarios	Additional Operating Profits Net of Income Tax		Additional Public Sector Revenue		Industry Share of Additional Surplus
	Sum	Present Value	Sum	Present Value	
125% Price-Increase Ratio vs. Baseline (100%)	36	16	15	7	70%
200% Price-Increase Ratio vs. Baseline (100%)	123	56	73	33	63%

Notes: (1) The size of the Additional Industry Operating Profits Net of Income Tax can be viewed as the industry's market-power premium. (2) Industry share of additional surplus is calculated by dividing additional industry operating profits by the sum of additional profits and additional public sector revenues, using the present value amounts.

Appendix

An Analysis of the Proposed Antitrust Immunity For Tobacco Product Manufacturers

The proposed Tobacco Settlement contemplates enabling legislation that, among other things, would grant antitrust immunity for collaboration and joint conduct by the cigarette manufacturers for the purpose of achieving the goals of the settlement. This Appendix will assess the possible need for immunity and the degree to which the proposed language is tailored to that need. The discussion takes as given that the goals of the settlement are legitimate and that the intent of the parties in proposing an exemption is simply to accomplish those goals without undue antitrust risk.

Antitrust Implications of the Proposed Settlement

The proposed tobacco settlement has, as a major goal, the reduction of tobacco usage by adolescents. To that end, the proposed settlement calls for a number of restrictions on marketing and advertising activities of cigarette manufacturers, including a ban on all outdoor tobacco product advertising, a ban on tobacco advertising on the Internet that would be accessible within the United States, restrictions on point-of-sale advertising in retail establishments that are accessible to minors, and a number of other restrictions.[112] In addition, the settlement would require the manufacturers to make annual payments (denominated in the proposed settlement as "Industry Payments" or "Annual Payments"), part of which would fund various federal and state programs relating to tobacco usage; the settlement contemplates that these payments would be passed on to consumers through higher cigarette prices to discourage smoking by minors.[113] These and other provisions of the proposed settlement would be implemented through federal legislation, consent agreements between the manufacturers and individual States, and an industry "Protocol" that would bind the manufacturers to the requirements.

Whether the proposed settlement might require some form of antitrust immunity depends in large measure on whether agreement among the manufacturers on price or other sensitive elements of competition is necessary to achieve the settlement's goals. There are two principal classes of conduct contemplated by the settlement that might have antitrust implications if implemented by agreement among the manufacturers: the pass-through of Annual Payment amounts and the restrictions on marketing and advertising activities. In addition, it has been suggested that manufacturers may find it necessary to join forces to deal with retailers that

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[112] See Title I, Part A.

[113] See Title VI, Part B.7.

undermine efforts to reduce smoking by adolescents — for example, by terminating sales to such retailers.

An agreement concerning pass-through amounts likely would be viewed as a restraint on price competition, one of the most serious of antitrust violations. An agreement on price is per se unlawful (i.e., without consideration of actual effects or possible justifications) unless it is a reasonably necessary aspect of some cooperative relationship that may result in efficiencies and enhance competition. Certain kinds of marketing or advertising restraints that are directly related to price, such as a restraint on price advertising, could have similar detrimental effects on price competition and would be regarded as per se unlawful.

Restraints that are less directly related to price, such as limits on advertisements that draw consumer attention to the attributes of a particular brand, could also have adverse effects on competition. For example, such a restraint could lead to non-competitive pricing by enabling the firms to better coordinate their conduct along the remaining dimensions of business conduct, either tacitly or overtly, with less concern that one of them will seek to gain a competitive advantage through the kind of advertising that has been restricted. Such restraints are evaluated under a "rule of reason" analysis that balances the anticompetitive effects against any procompetitive effects of the arrangement.

An agreement by manufacturers to stop dealing with retailers that failed to curtail sales to minors would be regarded as a group boycott. Such boycotts are sometimes treated as per se unlawful, although under many circumstances they are afforded "rule of reason" treatment.

The Immunity Provision

Those proposing the settlement appear to contemplate that implementation of the settlement would, indeed, involve joint action by the manufacturers on price and other competitive restraints, and therefore would entail a risk of antitrust liability. To remove this risk, the settlement proposes a general grant of antitrust immunity for actions undertaken in furtherance of the settlement and the proposed statute. The settlement agreement provides:

> In order to achieve the goals of this Agreement and the Act relating to tobacco use by children and adolescents, the tobacco product manufacturers may, notwithstanding the provisions of the Sherman Act, the Clayton Act, or any other federal or state antitrust law, . . . jointly confer, coordinate or act in concert, for this limited purpose. Manufacturers must obtain prior approval from the Department of Justice of any plan or process for taking action pursuant to this

section; however, no approval shall be required of specific actions taken in accordance with an approved plan.[114]

The Asserted Need for, and Appropriate Scope of, Antitrust Immunity

The desire for an antitrust immunity appears to focus on three hypothetical situations: (1) manufacturers may have to discuss and agree on issues relating to the pass-through of Annual Payments amounts; (2) manufacturers may have to agree on implementation of the proposed marketing and advertising restrictions; and (3) manufacturers may find it necessary to join forces to deal with retailers that undermine efforts to reduce smoking by adolescents. The following discussion considers whether any of these situations is realistic and warrants a grant of immunity and, if so, how that immunity might be framed to avoid unintended harm to competition.

(1) Collaboration on the Pass-Through of Annual Payment Amounts

The proposed settlement contemplates that "[i]n order to promote maximum reduction in youth smoking, the statute would provide for the Annual Payments to be reflected in the prices manufacturers charge for tobacco products."[115] The proposal for antitrust immunity raises two issues in that regard. First, is collaboration by the manufacturers on the pass-through amounts necessary to give effect to this goal? Second, what unintended consequences — beyond achievement of this goal — could antitrust immunity have?

On the first issue, no antitrust exemption would be needed for firms individually to comply with a legal requirement that they pass on the Annual Payments. Even without such a requirement, the historical record and economic logic demonstrate that firms would be able to pass on the Annual Payments required by the settlement without an antitrust exemption. This is because the Annual Payments would be treated as an added (marginal) cost of business and would be taken into account in setting price. In fact, as discussed in section II of this report, cigarette manufacturers, even without express collaboration, could increase prices by at least the amount of the Annual Payments, and might well be able to increase prices by more than that amount.

On the second issue, unintended consequences, it should first be recognized that the proposed regime for implementing immunity is somewhat unusual. Statutory grants of immunity for joint action of competitors more typically exclude specific classes of commerce from the

[114] Appendix IV, part C.2.

[115] Title VI, part B.7.

antitrust laws[116] or exempt a specific transaction[117] or agreement[118] that has been approved by a federal agency, usually in the context of a regulated industry.[119] Prior approval of an agreement

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[116] Examples include the Webb-Pomerene Act, 15 U.S.C. §§ 61-66 (1994), which provides a limited exemption from the Sherman Act for associations formed solely for the purpose of engaging in export trade; Section 6 of the Clayton Act, 15 U.S.C. § 17 (1994), and the Capper-Volstead Act, 7 U.S.C. §§ 291-292 (1994), which grant broad immunity to agricultural cooperatives engaged in the processing and marketing of certain products; the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-15 (1994), which excludes the "business of insurance" from the reach of the antitrust laws (with the exception of boycotts) to the extent that the business is regulated by state law; and the Shipping Act of 1984, 46 U.S.C. app. §§ 1701-1721 (1994), which immunizes the activities of ocean common carriers in the foreign commerce of the United States, so long as the activity is undertaken pursuant to an agreement filed with the Federal Maritime Commission, or an agreement that is not required to be filed. The statute describes the specific kinds of agreements that are subject to the filing requirement. See 15 U.S.C. app. § 1708.

[117] Examples include the Interstate Commerce Commission Termination Act (ICCTA), which exempts from the antitrust laws railroad mergers approved or exempted by the ICC (now the Surface Transportation Board), see 49 U.S.C.A. § 11321(a) (West 1996); a provision of the Sports Broadcasting Act that permitted the merger of two professional football leagues, 15 U.S.C. § 1291 (1994); the Newspaper Preservation Act, which exempts, subject to approval by the Attorney General of the United States, joint operating agreements between newspapers in economic distress, 15 U.S.C. § 1803; and a provision of the ICCTA which exempts a merger of motor carriers of passengers if approved by the Surface Transportation Board, 49 U.S.C. §1403.

[118] Examples include the Federal Aviation Act, 15 U.S.C. §§ 41308-41309 (1994), which authorizes the Department of Transportation to approve and exempt from the antitrust laws code sharing and other marketing agreements between U.S. and foreign air carriers; the approval of motor carrier rate bureau agreements by the Surface Transportation Board, see 15 U.S.C.A. §§ 13703-13704 (West 1997); the approval of motor carrier service pooling agreements by the STB, see 49 U.S.C.A. §14302; the approval of rail carrier rate agreements by the STB, see 49 U.S.C.A. § 10706; and the Sports Broadcasting Act, 15 U.S.C. §§ 1291-1295 (1994), which exempts certain agreements by the members of professional baseball, basketball, football or hockey leagues to pool their television broadcast rights for sale in a package to purchasers such as television networks.

[119] In addition, there has been a trend to deregulate industries and remove antitrust immunities. For example, section 601(b)(2) of the Telecommunications Act of 1996 repealed the FCC's ability to confer immunity to telephone company mergers that were submitted to the FCC for review, and DOT's authority to approve domestic airline mergers expired in 1989 pursuant to 49 U.S.C. app. § 1551 (1988); such mergers are now subject to ordinary application of the antitrust

(continued...)

by a federal agency has not been required where the scope of the immunity was very limited,[120] but broader grants of immunity have been accompanied by strict controls on the development and implementation of agreements.[121] In contrast, the immunity proposed in the tobacco settlement does not seek to exempt defined categories of transactions or agreements, and the scope of its application is left for future determination.[122] For example, the broad language of the proposed immunity provision could be construed to permit manufacturers to agree on the actual prices of their cigarettes, not simply on the amount of their Annual Payments. The result could well be a price increase that would exceed substantially the Annual Payment amounts and would substantially increase the manufacturers' profits.[123]

Even if the immunity provision were read as authorizing agreement only to the extent of ensuring a 100 percent pass-through of costs, immunity, once granted, could have effects not contemplated by the statute. Not only would it be difficult to monitor and control the manufacturers' collaborations to ensure that the prescribed boundaries are not exceeded,[124] but

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[119](...continued)
laws. Similarly, there has been substantial reduction of rate regulation of motor and rail carriers under the Interstate Commerce Act.

[120] For example, the Television Program Improvement Act of 1990, Pub. L. No. 101-650, § 501, 104 Stat. 5089 (1990), granted an antitrust exemption for agreements among participants in the television industry for the purpose of "developing and disseminating voluntary guidelines designed to alleviate the negative impact of violence in telecast material." The exemption was limited to a three-year period following enactment of the law, and did not apply to any joint action that resulted in a boycott of any person.

[121] For example, the Defense Production Act of 1950, 50 U.S.C. App. § 2158, and the International Energy Program, 42 U.S.C. § 6272, provide broad grants of antitrust immunity for voluntary agreements to accomplish specific national objectives, but both statutes contain detailed provisions for monitoring the formation and execution of such agreements, including rulemaking for the establishment of standards and procedures for such agreements, public notice of meetings to discuss the development of such agreements, and participation in such meetings by representatives of the Federal Trade Commission and the Department of Justice.

[122] Manufacturers are left to determine on their own, in the first instance, what joint activity may be appropriate to carry out the purposes of the statute. Although those determinations are subject to review, the resolution may require costly litigation.

[123] See Section II of this report.

[124] There are many examples in antitrust law where a meeting of competitors for otherwise legitimate purposes resulted in law violations when their discussions crossed permissible

(continued...)

the back-and-forth communications, even on "permissible" pass-through of costs, could well affect the firms' pricing behavior on subjects that were not the subject of explicit agreements. For example, during the course of such discussions firms could signal an intention to pass through more than 100 percent of their costs, or even signal an intention regarding price. Such "signaling" behavior can raise serious concerns under antitrust law because it can enable firms to coordinate their actions without reaching explicit agreements.

The generality of the immunity provision forces great reliance on the provision requiring prior approval by the Department of Justice of "any plan or process for taking action pursuant to this section."[125] That provision, however, may not be effective in preventing a number of anticompetitive agreements because the Department would not be able to require prior approval of "specific actions taken in accordance with an approved plan."[126] This provision is vaguely worded and may permit the manufacturers to engage in activities that are not fully disclosed to the Department. For example, the plan submitted for Department approval might be an industry resolution committing its members to operate in accordance with the purposes of the legislation, and the undisclosed "specific action" undertaken pursuant to that plan could be a price-fixing agreement or an agreement on other aspects of business conduct that could result in higher prices and industry profits. Issues will arise as to the scope of an "approved plan," what actions may reasonably be taken "in accordance" with an approved plan, and whether those actions are reasonably necessary to carry out the purposes of the statute. While the Department might be able to mitigate some of these problems by requesting additional disclosures before approving a plan (as it does in reviewing a request for a Business Review Letter) and by conditioning immunity on adherence to the factual representations made in seeking approval, it is unlikely that

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[124](...continued)
boundaries. For example, members of a trade or professional organization may adopt a code of conduct that in most respects is perfectly acceptable under the antitrust laws, but some provisions may unreasonably restrict competition.

[125] The provision assigns oversight responsibilities solely to the Department of Justice. Both the Federal Trade Commission and the Department of Justice, however, have jurisdiction in most industries that are generally subject to the antitrust laws, which would still be true of the cigarette industry apart from the special immunity provision proposed by the settlement, and the responsibility for handling a particular matter is decided through an inter-agency liaison process. In recent years a substantial amount of antitrust work involving the tobacco industry has been handled by the FTC, including the 1994 litigation challenging the acquisition of American Tobacco by B.A.T Industries p.l.c. The FTC also has major responsibilities involving marketing and advertising practices of the tobacco industry under Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45, and the Federal Cigarette Labeling and Advertising Act, 15 U.S.C. § 1331.

[126] <u>See</u> Appendix IV, part C.2.

it would be able to anticipate all contingencies. And in contrast to a Business Review Letter, the purpose of immunity might be to *change* the legal standard that antitrust law would apply, not merely to clarify it. Consequently, the extensive set of doctrines that have developed to interpret the antitrust laws might not be available to aid in interpretation.

In short, it appears that immunity is not necessary to assure the pass-through of the Annual Payments, and that the proposed immunity could have substantial unintended consequences that would not be cured by the broad requirement that a plan for taking action be reviewed by the Department of Justice.

The foregoing discussion focuses on assuring the pass-through of costs once they are paid by the individual manufacturers. A related issue is whether immunity is required so that the manufacturers can discuss and agree among themselves as to what portion of the Annual Payments each will bear. Such discussion does not appear to be a necessary part of implementing the proposed settlement. Although the proposed settlement does not specify precisely how the Annual Payments are to be allocated, if it contemplates allocation by each manufacturer's share of sales or some similar allocation method, some mechanism would be needed to determine periodically what that share is. However, there would be no need for direct discussion among the manufacturers in order to do so. The statute could simply direct the companies to transmit sales information to a neutral third party that would make the appropriate adjustments. No immunity would be needed beyond that statutory directive.

(2) Collaboration on Marketing Restraints Due to First Amendment Concerns

Another argument that has been raised as a reason for providing antitrust immunity is that certain marketing or advertising restrictions may have to be implemented by agreement among the manufacturers. At first blush, it is not clear why such agreement would be necessary, since no antitrust issue would be raised if the legislation embodied the restrictions and each manufacturer simply complied unilaterally with the statutory requirements. Although each manufacturer would be expected to conform to the same standards of conduct, that would be achieved through operation of the statute, and collaboration with competitors would be unnecessary. The argument has been made, however, that legislation imposing such restrictions might be challenged by a nonparticipant in the settlement as a violation of the First Amendment guarantee of freedom of expression. If such a challenge were successful, and were to result in complete invalidation of the provision (as opposed to its unenforceability against any company that had not waived its First Amendment rights by entering into the settlement), the participant companies would no longer be under a legal obligation to refrain from the specified types of advertising and marketing.[127] They might nonetheless have some incentive to refrain from such

[127] This assumes that their obligation to refrain from such advertising and marketing as embodied in their consent decrees with the states (III.B. of the settlement) would fall along with (continued...)

advertising and marketing in order to help meet the targets for reducing youth smoking and thus avoid the penalties for failing to meet that target, so long as they could be assured that most other companies would similarly refrain from such advertising and marketing.[128]

Without intimating any views on the possible success on the merits of such a First Amendment challenge, it appears that there is a realistic possibility that such a challenge could be brought.[129] Assuming, for purposes of this discussion, that such a challenge resulted in complete invalidation of the advertising and marketing restraints, and that the participating firms

Answer should be: no leg, but consent decrees protected)

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[127](...continued)
the parallel requirement in the federal statute. If not, reasonable arguments could be made that activities undertaken in compliance with a consent decree issued by a state court would not violate the antitrust laws. Actions in compliance with the order could be viewed as unilateral conduct, notwithstanding the manufacturer's agreement to accept such an order, because the court's order becomes a separate, enforceable command. Cf. Fisher v. City of Berkeley, 475 U.S. 260 (1986). Alternatively, to the extent that compliance with the order is viewed as joint conduct, it may be exempt from the antitrust laws under the "state action" doctrine enunciated by the Supreme Court in Parker v. Brown, 317 U.S. 338 (1943) (holding that the antitrust laws were not intended to apply to the actions of a state). If greater certainty is desired, however, one could provide authorization for a limited grant of immunity on a contingent basis, as discussed in the text.

[128] In all likelihood, they could not count on universal compliance, since, at a minimum, the company that had taken the trouble to mount a First Amendment challenge would likely seek to achieve a competitive advantage by engaging in the specified forms of advertising and marketing at a time when most of its competitors did not. Given this likelihood, it may be that the other companies would be unable to reach an agreement to refrain from such advertising and marketing. For purposes of this discussion, however, we assume that the participants would wish to reach such an agreement and that such an agreement would be desirable. The question we address, therefore, is whether antitrust immunity might be necessary for such an agreement to be reached.

[129] For one thing, a First Amendment challenge has already been brought against similar (but in some ways less restrictive) cigarette marketing provisions adopted by the Food and Drug Administration. The case is pending before the United States Court of Appeals for the Fourth Circuit. Coyne Beahm, Inc. v. FDA, 966 F. Supp. 1374 (M.D.N.C. 1997), appeal pending. The merits of such a case could be complex. Courts have held that advertising constitutes "commercial speech" that is entitled to qualified protection under the First Amendment, e.g., 44 Liquormart, Inc. v. Rhode Island, 116 S. Ct. 1495 (1996); Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n, 447 U.S. 557 (1980), but that the Constitution affords lesser protection to commercial speech than to other constitutionally guaranteed expression, Central Hudson, 447 U.S. at 562-63.

wished to agree with each other to continue to refrain from such advertising and marketing despite the successful challenge and despite the fact that at least some firms would likely begin such advertising and marketing,[130] such an agreement might become the subject of an antitrust suit as a restraint of trade. While the availability of advisory opinions from the FTC or the Department of Justice could eliminate uncertainty regarding a possible suit by the antitrust agencies, it could not provide any assurances against antitrust challenges from private parties. Accordingly, if it is desired to remove that uncertainty, so as to encourage the manufacturers to refrain from such advertising and marketing in the event of a successful First Amendment challenge, some provision for immunity might be necessary. Such a provision would need to be carefully circumscribed, however, to avoid the kinds of unintended consequences described in the previous section. It would need to be limited to implementing specific marketing restrictions and not allow discussions on price. Moreover, since the prospect for a successful First Amendment challenge is still speculative, the exemption could be made contingent on that event, or authorization could be given to the antitrust enforcement agencies to grant a specific exemption if that prospect were realized.

(3) Joint action to address problems associated with uncooperative retailers

The third concern is that the sales practices of some retailers may frustrate the manufacturers' efforts to reduce adolescent smoking at the target rates specified in the settlement and proposed legislation. Failure to meet the target rates would result in monetary penalties for the manufacturers, and a state could lose part of its allocation of funds from the manufacturers' Annual Payments. The argument is that joint action may be needed to respond to demands by a state to reduce sales to such retailers.

The hypothetical (and, at this point, speculative) situation would not seem to warrant antitrust immunity for private enforcement against non-complying retailers because there are other ways to address those concerns. First, the proposed legislation already contains sufficient incentives for the manufacturers to respond individually to non-complying retailers. There are strong penalties for not meeting target reductions in underage smoking, but the proposed legislation provides for abatement of the penalty if a manufacturer has acted in good faith and taken all reasonable steps to achieve the required reductions.[131] A unilateral decision to reduce or stop dealing with a non-complying retailer would be evidence of good faith, and hence a manufacturer would have a strong incentive to do so. No antitrust immunity would be required to achieve this result.

not any more!

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[130] See note 16, supra.

[131] See Title II and Appendix IV. Failure to take steps that may violate the antitrust laws (such as a boycott) presumably would not be evidence of bad faith or failure to take reasonable steps. The proposed legislation could provide assurances to that effect. A state could avoid a reduction of its allocation of funds on similar grounds.

Second, there would be mechanisms for enforcement by the state if a retailer fails adequately to control sales to minors. For example, the state could suspend or revoke the retailer's license to sell cigarettes, or assess other penalties.[132] Similarly, if there is a problem with legal-age persons buying for minors, that also could be addressed through state enforcement.

In sum, based on our understanding of the possible factual situations as presented thus far, it is unnecessary to authorize antitrust immunity for boycott activities against uncooperative retailers.

Conclusion

In summary, the proposed immunity provision appears to be unnecessary to achieve the contemplated pass-through of Annual Payment amounts or to deal with retailers that fail to curtail sales to minors, and to be far broader than necessary to allow adherence to the marketing restrictions in the event of a First Amendment challenge. Moreover, passage of an unnecessary or overly broad immunity runs the risk of facilitating price increases greater than that required simply to pass through the per-unit cost of their Annual Payments.

[132] See Title I, part D, and Appendix II.

Tobacco-settlement - Ind. perf.

	Teen Smokers (millions)				Changes Compared to Current Law					
					Agreement + offset		$1 Ex Tax		$1.50 Ex Tax	
	Current Law	Agrmnt + offset	$1 Ex Tax	$1.50 Ex Tax	# decline	% decline	# decline	% decline	# decline	% decline
1995										
1996	3.456	3.456	3.456	3.456	0.000	0	0.000	0	0.000	0
1997	3.507	3.507	3.507	3.507	0.000	0	0.000	0	0.000	0
1998	3.546	3.546	3.546	3.546	0.000	0	0.000	0	0.000	0
1999	3.588	3.196	2.513	2.103	-0.392	11	-1.075	30	-1.485	41
2000	3.498	3.064	2.449	2.050	-0.434	12	-1.048	30	-1.448	41
2001	3.539	3.014	2.478	2.074	-0.524	15	-1.061	30	-1.465	41
2002	3.553	2.916	2.488	2.082	-0.637	18	-1.065	30	-1.471	41
2003	3.631	2.826	2.543	2.128	-0.805	22	-1.088	30	-1.503	41
2004	3.708	2.989	2.596	2.173	-0.719	19	-1.111	30	-1.535	41
2005	3.778	2.941	2.645	2.214	-0.837	22	-1.132	30	-1.564	41
2006	3.823	3.036	2.677	2.240	-0.787	21	-1.146	30	-1.583	41
2007	3.843	3.056	2.691	2.252	-0.787	20	-1.152	30	-1.591	41
2008	3.831	2.996	2.683	2.245	-0.835	22	-1.148	30	-1.586	41
2009	3.810	3.033	2.668	2.232	-0.776	20	-1.142	30	-1.577	41
2010	3.789	3.002	2.654	2.221	-0.788	21	-1.136	30	-1.569	41
2011	3.792	3.015	2.655	2.222	-0.777	20	-1.137	30	-1.570	41
2012	3.794	3.012	2.656	2.223	-0.781	21	-1.137	30	-1.571	41
2013	3.795	3.016	2.658	2.224	-0.779	21	-1.138	30	-1.571	41
2014	3.796	3.016	2.658	2.225	-0.780	21	-1.138	30	-1.572	41
2015	3.797	3.018	2.659	2.225	-0.780	21	-1.138	30	-1.572	41
2016	3.824	3.039	2.678	2.241	-0.785	21	-1.146	30	-1.583	41
2017	3.850	3.060	2.696	2.256	-0.791	21	-1.154	30	-1.594	41
2018	3.877	3.080	2.715	2.272	-0.796	21	-1.162	30	-1.605	41
2019	3.903	3.101	2.733	2.287	-0.802	21	-1.170	30	-1.616	41
2020	3.929	3.121	2.751	2.302	-0.808	21	-1.178	30	-1.627	41
2021	3.980	3.162	2.787	2.332	-0.819	21	-1.193	30	-1.648	41
2022	4.032	3.202	2.823	2.362	-0.830	21	-1.208	30	-1.669	41
2023	4.083	3.242	2.859	2.393	-0.841	21	-1.224	30	-1.690	41
2024	4.134	3.281	2.895	2.423	-0.853	21	-1.239	30	-1.712	41
2025	4.186	3.321	2.931	2.453	-0.864	21	-1.255	30	-1.733	41

Tobacco - settlement -
industry analysis

Q&As on FTC Tobacco Report

Q: Earlier today, the FTC released its analysis of the proposed tobacco settlement negotiated by the attorneys general. The FTC found that the agreement could result in additional profits for the tobacco industry of as much as $125 billion. What is your reaction?

A: While the plan the President announced last week focused on significantly reducing youth smoking and not on the cost to industry, we are confident that industry profits will not go up under the President's plan. The President's plan calls for stiff financial penalties on the industry unless it meets ambitious targets for reducing teen smoking. The FTC report explores the consequences of providing broad anti-trust exemptions to the tobacco industry. We will work with Congress to make sure any anti-trust exemptions are narrowly written so that the industry cannot simply collude to raise prices through the roof.

Q: Over the weekend, industry representatives in defending the settlement seemed to confirm what the FTC is reporting today -- specifically, that under the settlement they have reached with the AGs, when you factor in mark-ups by the wholesalers and retailers, the price of a pack of cigarettes would increase by the $1.50 the President has called for. Do you agree with the industry's analysis, which seems to be supported by the FTC report?

A: No we do not. First, a number of economists have studied the terms of the settlement and have concluded that the price increase that would result under the proposed settlement is around $0.60. Second, the FTC report supports this conclusion, and specifically contradicts the tobacco industry's claim. The FTC found that because of the competitive nature of the distribution system it is highly unlikely that wholesalers and retailers would be able to add to the price increase (pg. 26-27 of the FTC report).

Q: A number of the findings in the FTC report about industry profitability are said to mirror internal reports conducted by the Treasury Department for the White House. Is that correct? Also a number of members of Congress have asked to see the Treasury reports. Will you be making the Treasury analysis publicly available?

A: During our review our economists developed models and spread sheets to help us predict the affect different policies would have. For example, how does a rise in cigarette prices affect youth smoking rates. We have offered to make our experts and their modeling capability available to Congress. [Note: We're <u>not</u> planning to make the Treasury analysis public.]

Tobacco - settlement -
Industry Performance

Jerold R. Mande

08/05/97 12:07:26 PM

Record Type: Record

To: Bruce N. Reed/OPD/EOP, Elena Kagan/OPD/EOP, Elizabeth Drye/OPD/EOP

cc:

Subject: Industry quotes about the settlement

Here is an interesting item that ran on Borio's Tobacco web page this morning.

Quotes About the Settlement from the Tobacco Industry

"This gives shareholders and employees more certainty and consumers a respite from constant demonization of cigarettes."

— Martin Broughton, CEO of B.A.T. Industries PLC (Brown & Williamson)

"Most important, the agreement secures the tobacco industry's rightful place in the mainstream of legitimate U.S. commerce."

— Steven Goldstone, CEO of RJR Nabisco Holding Corporation

"We hope that legislation will move forward and with it bring a new era of cooperation and tolerance with regard to tobacco issues."

— Steven Parrish, Philip Morris Senior Vice President

"Putting an end to the litigation would free the cigarette makers to reassess their business. Initially the settlement would force the companies to make some changes, but throughout its long history the tobacco industry has always been as flexible as a rubber band snapping back into shape despite events that have stretched it to the limit."

— Jane Shea; editorial in Tobacco International, a tobacco industry trade publication

Regarding the provision eliminating the Tobacco Institute and the Council for Tobacco Research, "All we're going to do is change the name on the door. We're going to continue to do what we've always done. I don't understand why they're going through this exercise, frankly."

— Walker Merryman, Vice President, Tobacco Institute

And our personal favorite

"They want a big payoff and we want a peaceful life"

— Martin Broughton, CEO of B.A.T. Industries PLC (Brown & Williamson)

Tobacco - settlement -
Performance and
accountability

MEMORANDUM

TO: BRUCE REED, ELENA KAGAN

FROM: TOM FREEDMAN, MARY L. SMITH

RE: ECONOMIC FOCUS OF TOBACCO INDUSTRY

DATE: JUNE 30, 1997

WHITE HOUSE WORKING GROUPS

1. **REGULATORY: FDA, advertising, labeling, and environment.**

2. **PROGRAM AND BUDGET ISSUES: how to spend the money.**

3. **LEGAL ISSUES: liability, antitrust.**

4. INDUSTRY PERFORMANCE AND ACCOUNTABILITY:
   A) OVERALL ECONOMIC ANALYSIS OF THE TOBACCO INDUSTRY

      - **Makeup of tobacco industry and impact of settlement on industry in domestic market and internationally in terms of sales, profits, and projections**
      - **Advertising**
      - **Sporting events**
      - **Vending Machines**
      - **Impact on retailers generally**
      - **Farmers**

   B) PARTS OF AGREEMENT THAT HAVE DIRECT FINANCIAL IMPLICATIONS
      - **targets penalties and incentives (penalties on industry to reduce youth smoking)**
      - **provisions to keep out new start-ups or becoming foreign entities**

   C) INTERNATIONAL PIECE OF TOBACCO CONTROL
      - **advertising**
      - **different conduct overseas**
      - **general tobacco export promotion**

ANNOTATION OF ECONOMIC IMPACT OF TOBACCO SETTLEMENT

INDUSTRY PERFORMANCE AND ACCOUNTABILITY:

A) OVERALL ECONOMIC ANALYSIS OF THE TOBACCO INDUSTRY

- **Makeup of tobacco industry and impact of settlement on industry in domestic market and internationally in terms of sales, profits, and projections**

U.S. REVENUES AND CONSUMER SPENDING

- 25.5% of American adults smoke; 1996 consumer spending on tobacco products totaled $46.6 billion; and federal, state, and local excise taxes collected on cigarettes totaled $13.1 billion; world-wide cigarette sales in 1996 amounted to $295.8 billion. (WSJ, 6-23-97)

- Cigarette sales in this country are a $45 billion a year business. The cigarette makers--Philip Morris, R.J. Reynolds, Brown & Williamson, Lorillard, Liggett, and American Tobacco--collect $20 billion in U.S. sales. Taxes account for another $14 billion. The other $11 billion is split by retailers, wholesalers, and farmers. From their $20 billion in sales, the companies make a profit of about $8.4 billion. If the deal goes through, this profit could fall to about $6.7 billion, according to the securities firm Sanford C. Bernstein-- $925 million in lower sales and $800 million in interest on the payments. (Chicago Tribune, 6-22-97)

JOBS

- The Tobacco Institute's Industry Profile estimates that tobacco was a $65 billion industry that supported at least 662,402 jobs in 1994, the last year for which figures are available. (Washington Times, 6-16-97)

MARKET SHARE

- Phillip Morris has 50% of US cigarette market; RJR Nabisco has 25%; Brown & Williamson has 15% (N.T. Times 6-25-97)

OVERSEAS MARKET SHARE

- The tobacco industry might be helped by growing markets overseas. Philip Morris' market share in Central Europe and Eastern Europe grew from 22% in 1995 to 28% in 1996. Salomen Brothers estimates it will grow to 32% this year. (Baltimore Sun, 6-21-97)

UP-FRONT PAYMENT UNDER THE SETTLEMENT

- Philip Morris will provide the majority of the initial $10 billion payment (payment is based on stock market value) --Philip Morris will pay $6.5 billion; RJR Nabisco will pay $600 million (reflects RJR Nabisco's weaker financial position); Brown & Williamson (B.A.T.) will pay $1.7 billion; Lorillard (Loews) $720 million; and U.S. Tobacco (UST) $324 million (N.Y. Times 6-25-97)

PRICE INCREASES, FUTURE PROFITS AND STOCK VALUE

- The Value Line Investment Survey forecasts 1997 tobacco industry profits to be $13 billion and expects the long-term net profit growth rate to be 11 percent a year, excluding any impact from the negotiations. (NY Times, 6-26-97)

- Gary C. Black, and analyst with the securities firm Sanford C. Bernstein & Co., predicts that with an agreement, Philip Morris shares could rise to about $60 from about $45 and RJR shares could rise to $48 from about $34. Black believes that marketing expenses are going to drop and there will be no bankruptcy worry. Others disagree. The settlement will require tobacco companies to pay about $15 billion a year, a third of their annual U.S. sales of about $45 billion. Jack Maxwell, a tobacco industry analyst for Wheat First Butcher Singer, believes that the companies will have to borrow a lot of money. Art Cecil, a Baltimore-based analyst for T. Rowe Price, believe that if the price goes up 10%, there generally will be a 4% reduction in consumption. Sanford C. Bernstein estimates an 11% drop in per-pack sales. The settlement of outstanding legal claims would cut industry profits from $8.4 billion to $6.7 billion. (Baltimore Sun, 6-21-97)

- Pay-out averages $14.7 billion a year, more than double the industry's operating profits of $7.2 billion from domestic tobacco sales last year. Tobacco companies plan to offset the cost of the deal by increasing cigarette prices in the US by about 50 cents a pack, so the settlement will have the same effect as a big tax increase. The deal does nothing to impinge on the growth side of their business - their booming overseas sales, particularly in emerging markets. (Financial Times, 6-23-97)

- If the settlement passes Congress, the companies could lose $1.5 billion or so in profits next year, partly caused by lower sales and partly by interest on loans the companies will need to pay for the settlement. But the companies are still expected to make $6.7 billion in profits next year, deal or no deal. (Chicago Tribune, 6-22-97)

EXPECTED PRICE INCREASE AND IMPACT ON CONSUMPTION

- Cigarettes might go up 75 cents a pack. Some research shows that every 10% of price increase drives 12% of teen smokers to quit. (USA Today, 6-25-97)

- Poll shows that if settlement increases the cost of cigarettes by 75 cents a pack, 57% said that it would be somewhat likely to cause them to quit. 43% say the price increase would not impact their habit. (USA Today, 6-25-97)

- The 50-cents-a-pack price increase, more than any other aspect of the settlement, may affect people's propensity to smoke. Other countries have found that big price increases reduce demand for cigarettes, particularly among youngsters. Mr. Gary Black, an analyst with Sanford C. Bernstein, has estimated that the price increase could cut consumer purchases by 11%. (Financial Times, 6-23-97)

- John Maxwell, a tobacco analyst at Wheat First Butcher Singer in Richmond, VA, estimates that a 10% price increase usually cuts consumption about 2 to 3%, so a 75-cent increase could reduce smoking by about 20 to 30 percent. Manufacturers could turn to cheaper foreign tobacco, or push generic brands. These generic brands held 41% of the market in 1993, but have since slipped to only 27%. (Chicago Tribune, 6-22-97)

- Studies at the University of Chicago and elsewhere suggest volume sales could fall by as much as 8% for each 10% increase in prices. (Bergen Record, 6-21-97)

- The settlement could add 75 cents to $1 to the price of an average pack of cigarettes. Tax hikes being debated in Congress and in 16 states could raise the average price even more, from $1.85 to $3 or more. Marc I. Cohen, a tobacco analyst at Goldman Sachs & Co., estimates that if there is a 75-cent to $1 retail increase, it will cost the average carton-a-week smoker about $400 to $500 more a year. (Chicago Tribune, 6-22-97)

- Even with the expected price increases, international experience shows that most smokers will not quit. Cigarette prices in Europe already are more than $3 per pack; the average price in Norway is $7. Smoking is still very prevalent in Norway. (Chicago Tribune, 6-22-97)

DEAL/PENALTY

- $2 billion cap for reduction in youth smoking comes to 8 cents per pack of cigarettes sold annually, 3 cents of that is tax deductible, so the penalty is really 5 cents a pack (USA Today 6-25-97)

- The agreement provides for a financial penalty of up to $2 billion a year against the tobacco industry if it fails to cut under-age smoking by 60% over the next 10 years -seemingly, a form of guarantee that the deal will work. But the target looks so unrealistic as to suggest that tobacco manufacturers consider an extra $2 billion a year a price worth paying for the legal immunity they will gain. (Financial Times, 6-23-97)

DEAL/JOBS

- For tobacco industry workers, John Maxwell, a tobacco industry analyst at Wheat First Butcher Singer in Richmond, VA, says there will possibly be layoffs. (Chicago Tribune, 6-22-97)

BANS ON ADVERTISING AND IMPACT ON CONSUMPTION

- Canada imposed a ban on cigarette advertising in 1989. Since then, the percentage of Canadians who smoke has gone up from 30 to 31%. In Finland, teenage smoking has gone up from 22 to 24% since a partial advertising ban in 1978. (Chicago Tribune, 6-22-97)

- **Advertising**

  - Advertisers and ad agencies will not feel much of a pinch from the settlement because they have been shifting their business away from the tobacco companies for years. Billboard owners get about 10% of their total revenue from cigarette advertising. For magazines, it is less than 3%. And cigarette advertising has been banned from television for 26 years. (Chicago Tribune, 6-22-97)

  - According to John Fithian, counsel to the Washington-based Freedom to Advertise Coalition, even if Congress gives the advertising portion of the settlement the force of law, the advertisers can live with it because it will directly affect less than 1% of the industry's total revenues. (Chicago Tribune, 6-22-97)

- **Sporting events**
- **Vending Machines**
- **Impact on retailers generally**

  - Retailers will feel an impact from 3 directions: (1) the public may buy less; (2) the companies may try to shave their markets; and (3) smokers may switch to cheaper brands. Lindsay Hutter, from the National Association of Convenience Stores, says that cigarettes account for 26% of sales in members' stores and will put her members in a much more competitive squeeze. (Chicago Tribune, 6-22-97)

  - Convenience store owners take in $17.3 billion a year, 26% of their sales, by selling one out of every two cigarettes consumers smoke. Lindsay Hutter, of the Alexandria, VA-based National Association of Convenience Stores, even warns of a growing black market in tax-free tobacco, like the one that emerged after Canada raised taxes in the early 1990s. (Bergen Record, 6-21-97)

- **Farmers**

FEDERAL SUBSIDIES

- Federal government's subsidies for tobacco farming are relatively small. Direct subsidies ended in the 1980s. Now the subsidies amount to a quota system in which the government licenses the right to grow tobacco and has a federal program to insure farmers against crop losses. The Department of Agriculture has budgeted $145 million for the insurance in the coming fiscal year; in years with no significant losses, it contributes little or nothing to the insurance pool. (The Guardian, 6-24-97; NT Times, 6-23-97)

- Huge export market is helping to make up for drastic declines in domestic consumption, according to Blake Brown, an agricultural economist at North Carolina State University. About 40% of flue-cured tobacco, the kind produced in North Carolina, is exported. However, the farmers are earning less than in the 1970s, as is North Carolina as a whole. Tobacco was 46% of North Carolina's farm income in 1964, but was only 15% in 1994. (The Guardian, 6-24-97; NY Times, 6-23-97)

STATE STATISTICS

- Tobacco is a major crop in the Carolinas, Kentucky, Virginia, and other Southern states. But any ripple effect from the settlement would be felt most strongly in North Carolina, which produces 52% of all domestically grown tobacco. This is home base for much of the $45 billion-a-year tobacco industry. Both Philip Morris and RJ Reynolds, which together account for almost three-fourths of the cigarettes sold in the US, are based in North Carolina. There are about 17,000 tobacco farmers in North Carolina. Mark Vitner, a regional economist at First Union Corp. in North Carolina, said that two decades ago, the tobacco industry represented 20% of North Carolina's economy. Today tobacco accounts for only about 6.5% of the state's economy, or about $12 billion annually. (LA Times, 6-23-97)

- Kentucky and North Carolina are the largest tobacco-producing states. Last year North Carolina's crop sold for $871 million, which resulted in much tax dollars for the federal government. Blake Brown, an agricultural economist who tracks tobacco at North Carolina State University, says farm sales of tobacco generate 15 to 20% of the state revenue and tobacco accounts for about $12 billion of state receipts. Most of the tobacco grows in the North Carolina's eastern and piedmont regions. The crop accounts for one in 11 jobs in the state. This year the tobacco-growing quota is the largest it has been in 15 years. During the last three years, cigarette production has been breaking record levels. Brown says that cigarette production is on the rise and tobacco is on the rebound and attributes this increase to the European and Japanese markets. (Washington Times, 6-16-97)

- In Virginia, tobacco is the largest cash crop, bringing in $186 million for more than 8,000 farm families in 47 counties in 1996. Even though the state's 2 ½ cents-a-pack tax is the lowest in the nation, it generated $17 million in 1995. 29 cities and 2 counties added $33 million in 1995 in local cigarette taxes. A big part of tobacco's hold on Virginia is the $4,000 an acre that farmers take in for growing tobacco, compared with $136 an acre for wheat and not much more for other crops. Thousands of Mexicans harvest the tobacco fields --the pay is about $5.80 an hour; transportation to and from Mexico is provided, so is housing and health care. Foreign sales have kept the demand for Virginia tobacco high. This year there is an 11.5 % increase in the amount of tobacco that farmers can grow in the states. (Virginian-Pilot, 6-8-97)

- In 1950, North Carolina had 150,764 tobacco farmers; now there are 17,625. The crop back then accounted for 60% of farm income; now it accounts for 20%. While most farmers have diversified to other crops, they say they cannot afford to give up tobacco altogether because it remains the most profitable. (LA Times, 6-23-97)

- In Richmond, Philip Morris, which produces 600 million cigarettes per day, is the city's largest private employer, with 8,000 workers and a yearly payroll of $456 million. The company's suppliers account for another 17,000 jobs in the Richmond area. (Washington Times, 6-25-97)

- In Virginia, in 47 counties, 8,400 farms grow tobacco. Last year's crop brought farmers $186 million. 4% of Virginians earn their living from tobacco, directly or indirectly. (Washington Times, 6-25-97)

B) PARTS OF AGREEMENT THAT HAVE DIRECT FINANCIAL IMPLICATIONS

- **targets penalties and incentives (penalties on industry to reduce youth smoking)**
- **provisions to keep out new start-ups or becoming foreign entities**

C) INTERNATIONAL PIECE OF TOBACCO CONTROL

- **advertising**
- **different conduct overseas**
- **general tobacco export promotion**

  - The tobacco industry might be helped by growing markets overseas. Philip Morris' market share in Central Europe and Eastern Europe grew from 22% in 1995 to 28% in 1996. Salomen Brothers estimates it will grow to 32% this year. (Baltimore Sun, 6-21-97)

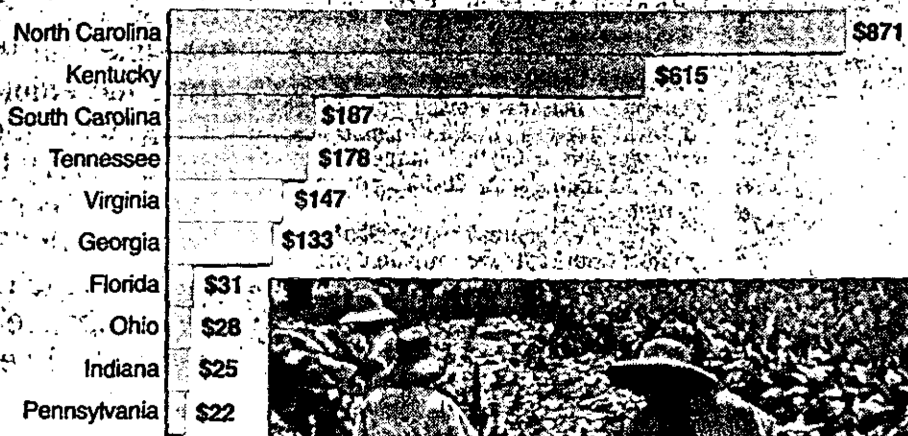
  - Foreign-grown tobacco has been improving in quality because of technological advancements. It is far cheaper than American tobacco, in part because of price supports and an American quota system that limits production in an attempt to keep demand high. Brazil, Argentina, Zimbabwe, and Malawi are now fierce competitors. (LA Times, 6-23-97)

USA Today 6-23-97
Business Section

Tobacco's deep roots in the economy

The tobacco industry contributes substantially to the U.S. economy. How much was added to the 1994 economy by people whose income came directly from a tobacco company, farm, supplier (makers of boxes, cellophane and other goods and services needed for tobacco products), or advertising agency that works on tobacco accounts.

Tobacco is grown on more than 124,000 farms in 23 states and Puerto Rico. Top 10 tobacco-producing states in 1995, by cash receipts:

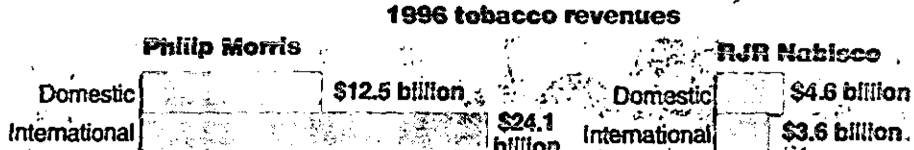


- Contribution to gross domestic product: **$44.7 billion**
- Jobs: **662,402**
- Federal/state/local taxes: **$20.6 billion**

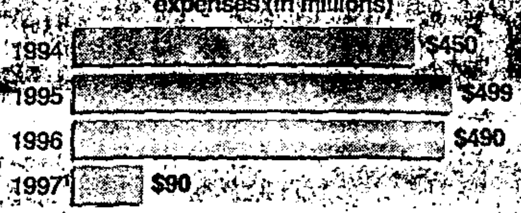
By Vidal Medina, Reuters

In the field: Workers harvest tobacco at a Maryland farm. In 1996, about 674,300 acres of tobacco were harvested in the USA — 1.32 billion pounds — down nearly 16% from 1994.

The USA's two biggest tobacco companies draw much of their tobacco revenue outside the USA



Tobacco companies are among Corporate America's leading advertisers



1 – January to March

Where tobacco ad dollars go:

	(In millions)
Magazines	$316.5
Event sponsorship	$2.0
Outdoor	$157.6
Cable TV networks	$0.8
Newspapers	$10.0
Sunday magazines	$5.3

The average price for a pack of cigarettes in the USA is $1.85. Average price by state, and how much of that cost is taxes:

	Price	Tax
Washington	$2.65	0.825
Massachusetts	$2.45	0.770
Hawaii	$2.43	0.600
Michigan	$2.34	0.750
Dist. Columbia	$2.30	0.650
New York	$2.23	0.560
Arizona	$2.22	0.580
Minnesota	$2.17	0.480
Rhode Island	$2.17	0.610
Alaska	$2.14	0.290
Connecticut	$2.09	0.500
Vermont	$2.02	0.440
Wisconsin	$2.01	0.440
California	$2.00	0.370
Illinois[1]	$1.99	0.440
Nevada	$1.99	0.350
Oregon	$1.98	0.680
New Jersey	$1.95	0.400
North Dakota	$1.94	0.440
Maryland	$1.91	0.360
Maine	$1.90	0.370
Texas	$1.90	0.410
Iowa	$1.89	0.360
Utah	$1.86	0.265
Nebraska	$1.85	0.340
Idaho	$1.84	0.280
Florida	$1.83	0.339
South Dakota	$1.82	0.330
Arkansas	$1.81	0.310
New Hampshire	$1.77	0.250
Pennsylvania	$1.77	0.310
New Mexico	$1.76	0.210
Colorado	$1.74	0.200
Delaware	$1.72	0.240
Oklahoma	$1.72	0.230
Kansas	$1.71	0.240
Mississippi	$1.69	0.180
Alabama[1]	$1.67	0.165
Louisiana	$1.67	0.200
Ohio	$1.67	0.240
Wyoming	$1.64	0.120
Montana	$1.65	0.180
Missouri[1]	$1.63	0.170
Tennessee[1,2]	$1.61	0.130
West Virginia	$1.61	0.170
Virginia[1]	$1.60	0.025
Georgia	$1.59	0.120
Indiana	$1.56	0.155
South Carolina	$1.54	0.070
North Carolina	$1.52	0.050
Kentucky[2]	$1.46	0.030

1 – Counties and cities may impose an additional tax
2 – Additional distribution fees charged

Sources: American Economic Group, Competitive Media Reporting and Publishers Information Bureau, The Tobacco Institute
USA TODAY research by Mary Cadden

By Marcy E. Mullins, USA TO[DAY]

Tobacco - settlement - industry performance

Jerold R. Mande

06/25/97 02:20:02 PM

Record Type: Record

To: Bruce N. Reed/OPD/EOP, Elena Kagan/OPD/EOP, Christopher C. Jennings/OPD/EOP, Elizabeth Drye/OPD/EOP

cc:
Subject: Some key tobacco stories not in WH clips

I have attached 4 stories I thought you should see.

Taxpayers Might Pay $147B Toward Tobacco Industry Deal
001 Newsday

Tobacco Institute Workers Confident of Reincarnation
\+ 027 Los Angeles Times

Tobacco Deal's Mountain of Cash Has Tetons Buzzing
028 Los Angeles Times

Senate review of tobacco case may take until '98
051 Winston-Salem Journal

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Taxpayers Might Pay $147B Toward Tobacco Industry Deal

Newsday
Wednesday, June 25, 1997
By Harry Berkowitz. STAFF WRITER

Taxpayers could end up subsidizing as much as $147 billion of the tobacco industry's landmark deal, tax experts said yesterday.

Under a clause in the deal - which requires the industry to pay $368.5 billion over 25 years - the industry's entire cost would be counted as "normal and necessary" business expenses rather than a penalty or fine.

That means, if Congress does not change the provision, the entire amount would be tax deductible, at the rate of about 40 percent between state and federal taxes, the experts said.

"If it were not in there, the argument could be made that the entire thing is a fine or penalty, which would be nondeductible," said Bill Fleming, an executive and tax expert with Coopers &

Lybrand in Hartford. If it is considered deductible, however, the cigarette companies would save $147 billion of the deal's cost.

At the very least, the Internal Revenue Service would likely argue that a $60-billion portion of the deal that won the industry protection from punitive damages in lawsuits should count as a penalty, Fleming said. If it is considered normal business expenses instead, the companies save $24 billion.

"If the money is going to be paid by Uncle Sam, the incentive is much smaller not to engage in the same misconduct in the future," said Richard Daynard, head of the Tobacco Products Liability Project at Northeastern University in Boston.

Steve Berman, a Seattle lawyer representing a dozen of the states that sued the industry to recover smoking-related Medicaid costs and agreed to the settlement, said the industry insisted that the clause be in the deal and would not give it up.

"They made a big stink," Berman said, adding that the $60 billion should count as punitive damages, which would make it a nondeductible penalty if not for the clause.

Negotiators also agreed to let the tobacco companies seek a rebate if they pay a penalty for falling short of goals to cut teen smoking. Those goals include a 60-percent cut over 10 years. The industry could face penalties of up to $2 billion a year for falling short. But if the industry shows that it did its best and the failure was beyond its control, it can get back 75 percent of that penalty.

Critics say the potential penalty is too small and the possible rebate is outrageous.

"The fines are not set high enough to provide a real disincentive to addicting kids," said Stanton Glantz, a critic of the deal and professor of medicine at the University of California at San Francisco.

Lance Morgan, a public relations consultant hired by the tobacco companies, said the rebate kicks in only if the industry proves its case.

"The burden of proof is on the industry in order to obtain that rebate," he said.

In another provision that's come under fire, if revenue from adult smokers declines enough, the companies would pay lower amounts into the settlement fund.

"It's like saying to a murderer if you don't murder as many people when you get out of jail, we will cut your sentence," said Joe Cherner, president of Smoke-Free Educational Services, an anti-smoking group in Manhattan.

Negotiators, however, said the provision makes sense. "It gives them an incentive to lower sales," said John Coale, a class-action lawyer involved in the talks.

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Tobacco Institute Workers Confident of Reincarnation

Los Angeles Times
Tuesday, June 24, 1997
By MARLENE CIMONS, Times Staff Writer

WASHINGTON--Although the landmark tobacco settlement announced last week requires the industry to abolish its controversial lobbying arm--the Tobacco Institute--the mood at the institute's office here on Monday was anything but grim.

"All we're going to do is change the name on the door," said institute vice president Walker Merryman, noting that the deal--with some stipulations--allows the formation of a new industry trade association after the old one has been dismantled.

Merryman added: "We're going to continue to do what we've always done. I don't really understand why they're going through this exercise, frankly."

Like other elements of the settlement, the proposed elimination of the institute--and its sister scientific organization, the Council for Tobacco Research U.S.A.--may not be all it initially appeared.

At least that's what folks at the institute think.

"No one around here is updating their resumes and overloading the copiers," Merryman said. "And my phone hasn't been ringing off the hook over this."

Both organizations, which are among the defendants in the numerous lawsuits filed against tobacco companies that would be settled in return for $368.5 billion under the deal announced Friday, have been regarded as key players in creating the industry's public image.

The settlement, which must be approved by Congress and the White House, calls for tobacco-product manufacturers to disband both the institute and the council within 90 days of the effective date of the deal.

But the deal goes on to say that the companies can form or participate in any new industry trade group, as long as for 10 years at least one-fifth of the new association's board of directors "shall be other than a current or former director, officer or employee of any association member or affiliated company."

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Tobacco Deal's Mountain of Cash Has Tetons Buzzing

Law: Gathering of attorneys general is filled with talk of dividing up $300 billion. But criticism of accord mounts.

Los Angeles Times
Tuesday, June 24, 1997
By MYRON LEVIN, HENRY WEINSTEIN, Times Staff Writers

JACKSON HOLE, Wyo.--Against the awesome profile of the Tetons, one of America's natural treasures, attorneys general from all 50 states Monday began considering how to divvy up an extraordinary treasure of a different kind: the roughly $300 billion that cigarette makers would pay in legal settlements to the states under the sweeping tobacco accord.

The annual meeting of the National Assn. of Attorneys General, being held at a lodge on the shores of Jackson Lake in Grand Teton National Park, was scheduled long before last week's announcement that a group of state attorneys general had settled litigation against the tobacco industry for $368.5 billion.

But the meeting here was abuzz with talk about how much lucre each state would get if the deal negotiated with the industry is approved by Congress and the White House. It appears that under almost any plan for dividing the loot, California would get roughly a half billion dollars or more annually through the life of the agreement, which initially covers 25 years.

Meanwhile, there was mounting criticism of the deal Monday as the 68-page settlement document began to receive thorough scrutiny from congressional and White House aides and public health advocates.

Among the troubling details they cited:

* The industry would be able to write off its payments, meaning that the taxpayers would bear about $110 billion to $120 billion of the costs of the settlement.

* Industry obligations could be reduced by as much as 1% for each percentage point drop in annual tobacco sales, creating an anomalous situation where the size of the settlement pot is at least partially dependent on millions of people continuing to smoke.

* The industry's obligation to pay penalties if youth smoking doesn't go down in five years could be dramatically reduced if the cigarette makers can convince the Food and Drug Administration that they have utilized all "reasonably available measures."

* A "passthr
ough" provision that may mean the industry's payments would all be financed out of raising prices, not out of profits.

These criticisms come on top of those already leveled by former Food and Drug Administration Commissioner David A. Kessler that provisions of the deal will make it very difficult for the agency to regulate nicotine content.

On Monday, a White House aide said the FDA provisions will be examined by the first of eight working groups formed by President Clinton to review the settlement. The president has told the working groups to complete their critique within 30 days, White House spokesman Barry Toiv said at a briefing.

The other working groups are to study: how the money will be spent, the impact of the settlement on the industry, workplace smoking, smoking-cessation programs, the impact on litigation and the industry's obligations to disclose internal documents, international issues and how the agreement would be implemented.

The massive settlement, in addition to being the costliest to an industry in history, calls for the tobacco companies to submit to FDA jurisdiction; eliminate their most potent advertising symbols; fund a nationwide, government-run anti-smoking campaign; and pay billions for smoking-cessation programs.

In return, the industry secured significant protections against future legal liability. Among them are a $5-billion cap on the amount of damages it would have to pay in any given year, a ban on class-action lawsuits, a ban on Medicaid-recoupment suits and a prohibition on punitive damages in any of the individual product-liability cases now pending in courts around the country.

On the first day of the meeting in the Tetons, reporters flocked around Mississippi Atty. Gen. Mike Moore, who filed the first state lawsuit against the industry in May 1994, persuaded other states to join in to make the attack a mass movement and then spearheaded the negotiations that led to the settlement.

Bristling at comments by some critics, who said the industry yielded too little for the liability protections it got, Moore remarked: "To the naysayers, I say, 'OK, guys, you do it. This country has been waiting 50 years for you to do it.' "

Some skeptics, led by Sen. Edward M. Kennedy (D-Mass.), contend that the settlement fund is not nearly large enough because it

Tobacco-Settlement -
Industry Performance

Jerold R. Mande

06/26/97 12:48:07 PM

Record Type: Record

To: Bruce N. Reed/OPD/EOP, Elena Kagan/OPD/EOP, Paul J. Weinstein Jr./OPD/EOP, Elizabeth Drye/OPD/EOP

cc: Christopher C. Jennings/OPD/EOP, Toby Donenfeld/OVP @ OVP
Subject: FYI... Koop-Kessler recommendation on performance penalties

I wrote this down from their meeting yesterday. These are the points that were agreed to by consensus (including Heart, Cancer, AMA, the Campaign) for inclusion in their "blueprint," which is their effort to set the right public health agenda. They will also have a second document, a "letter," that will be a side-by-side of their blueprint and the proposed settlement.

"First, and most important: Failure to meet youth smoking reduction targets must lead to severe, predictable sanctions that would serve as a significant financial deterrent directly affecting shareholder value of industry companies.

2. The tobacco industry should be required to meet increasingly stringent youth tobacco consumption reduction targets every year, beginning with the second year.

3. No caps on any penalties that are related to meeting targets.

4. Will remain silent in blueprint on this matter because it is not a public health question, but decided there should not be a rebate or abatement provisions.

5. There should be non-financial penalties (e.g., plain packaging) for missing youth reduction targets.

6. Funds collected from penalties should be used to further reduce consumption of tobacco products with youth as the first priority.

7. Performance penalties should be assessed on a company by company basis.

8. There should be some industry oversight apparatus to help insure compliance with the youth reduction targets that would include review of industry behavior and help insure appropriate incentives."

Tobacco - settlement -
industry performance

Bruce N. Reed
06/23/97 04:17:23 PM

Record Type: Record

To: Paul J. Weinstein Jr./OPD/EOP

cc: Elena Kagan/OPD/EOP, mazur_m @ a1 @ cd @ lngtwy
Subject: Re: tobacco industry analysis working group

That looks like a good starting point. A few more ideas:

1. I assume the industry effects group will conduct a full analysis of the tobacco market, foreign and domestic, and look at how they spend their money (advertising, lawyers, etc.).

2. I wouldn't use the phrase "true terms" -- perhaps something more neutral like "Revenue Projections"

3. I would create a 3rd group (headed by Summers) on "Demand Impacts". This group would look at the youth smoking performance incentives in the settlement, at the settlement's overall impact on adult demand, and at the economic impact and benefits of reducing demand.

4. At some point, we will want to make estimates about how much this settlement (or a modified version) would reduce smoking, how many lives it will save, how much it will save the economy and the govt in smoking-related costs, how we measure the impact of people living longer. The FDA rule included a substantial cost-benefit analysis, which we may have to replicate. That will require a cross-cutting effort by all the teams, not just the industry analysis ones.

Tobacco - settlement - industry analysis

Paul J. Weinstein Jr. 06/24/97 06:42:46 PM

Record Type: Record

To: Elena Kagan/OPD/EOP

cc: Laura Emmett/WHO/EOP
Subject: Tobacco/Economic Analysis Meeting

The one I sent before was a mistake. Sorry.

---------------------- Forwarded by Paul J. Weinstein Jr./OPD/EOP on 06/24/97 06:42 PM ---------------------------

Paul J. Weinstein Jr. 06/24/97 06:23:03 PM

Record Type: Record

To: Cathy R. Mays/OPD/EOP

cc: Bruce N. Reed/OPD/EOP, MAZUR_M @ A1 @ CD @ LNGTWY
Subject: Tobacco/Economic Analysis Meeting

Tobacco Industry Analysis Meeting

Participants

Bruce Reed (DPC)
Paul Weinstein (DPC)
Mark Mazur (DPC/CEA)

Larry Summers (Treasury)

Josh Gottbaum (OMB)

Alicia Munnell (CEA)

Peter Orszag (NEC)

Labor -- Ed Montgomery (Labor, Chief Economist)

Joe Glauber (USDA, Chief Economist)

Lee Price (Commerce, Chief Economist)

Groups

1) Effects on Industries: Suggested Lead -- Alicia Munnell/CEA

- Tobacco (shareholders, managers, workers)
- Farmers
- Advertising/Communications
- Sports
- Transportation
- Retail/Vending Machines

Note: The industry effects group will conduct a full analysis of the tobacco market, foreign and domestic, and look at how they spend their money (advertising, lawyers, etc)

2) Revenue Projections of Settlement: Suggested Lead -- Josh Gotbaum/OMB

- Price Per Pack
- Present Value
- Potential Decreases and Increases of Payments

~~3)~~ Antitrust/Legal Implications: Suggested Lead -- Alicia Munnell/CEA - DOJ

4) Effect on Stock Prices: Suggested Lead -- Summers/Treasury

5) Demand Impacts: Suggested Lead -- Summers/Treasury

Note: This group will look at the youth smoking performance incentives in the settlement, at the settlement's overall impact on adult demand, and at the economic impact and benefits of reducing demand.

Government/Economic Savings: Suggested Lead -- Gottbaum/OMB

Note: This group will look at whether the settlement will reduce smoking, thus saving lives and the impact on the economy and whether the settlement will reduce smoking- related costs to the Federal government.

Tobacco - Settlement -
Industry performance

Bruce N. Reed
06/26/97 12:48:22 PM

Record Type: Record

To: See the distribution list at the bottom of this message

cc:
Subject: International

Paul, by my calculations based on the business info you sent me, about 5 trillion cigarettes are sold worldwide outside the U.S. -- and only around 150 billion or so are from U.S. cigarette makers. (Phillip Morris 65 billion, RJR 41 billion; I couldn't find figures for US Tobacco and Loews). Are we really only 3% of the non-U.S. world market for cigarettes?

Message Sent To:

Paul J. Weinstein Jr./OPD/EOP
Jerold R. Mande/OSTP/EOP
Elena Kagan/OPD/EOP
Elizabeth Drye/OPD/EOP
Mark J. Mazur/CEA/EOP

Tobacco - settlement -
performance wkg gp

Paul J. Weinstein Jr. 06/23/97 03:54:24 PM

Record Type: Record

To: Bruce N. Reed/OPD/EOP

cc: Elena Kagan/OPD/EOP, MAZUR_M @ A1 @ CD @ LNGTWY
Subject: tobacco industry analysis working group

Tobacco Industry Analysis Working Group

Coordinators -- Mazur/Weinstein/DPC

Groups

1) Effects on Industries: Alicia Munnell/CEA

- Tobacco (shareholders, managers, workers)
- Farmers
- Advertising/Communications
- Sports
- Transportation
- Retail/Vending Machines

2) True Terms of Settlement: Josh Gotbaum/OMB

- Price Per Pack
- Present Value
- Potential Decreases and Increases of Payments

3) Antitrust/Legal Implications: Justice and/or CEA

4) Effect on Stock Prices: Summers/Treasury

Other Participating Agencies

Labor -- Ed Montgomery (Chief Economist)
USDA -- Joe Glauber (Chief Economist)
Commerce -- Lee Price (Chief Economist)
NEC -- Peter Orszag -- (Senior Economic Advisor)
HHS -- ***Should we have somebody from HHS?
OVP -- ***Should we have somebody from OVP?

Tobacco - Industry performance

Thomas L. Freedman
07/16/97 11:41:00 AM

Record Type: Record

To: Bruce N. Reed/OPD/EOP, Elena Kagan/OPD/EOP

cc: Mary L. Smith/OPD/EOP, Elizabeth Drye/OPD/EOP, Jerold R. Mande/OSTP/EOP
Subject: tobacco growers

A couple of points for the meeting with growers: 1. the profitablity of this crop is striking, sometimes 10 times or higher compared to other crops on a per acre basis; 2. accordingly, a key recommendation from the growers groups is the companies be required by the settlement to keep buying 600 or 700 million tons a year.

Tobacco -
industry performance

THE PRESIDENT HAS SEEN
7-7-97

INTRINSIC VALUE/BY ROGER LOWENSTEIN

Even With Settlement, Big Tobacco Can't Lose

The economics of tobacco are so unbelievable that the industry was able to grossly overpay to buy itself peace, underwrite real advances for public health and emerge with its killer instinct for profit satisfied. In an imperfect world, the recent settlement is a win for both sides.

Before Big Tobacco folded, its expected liability was far less than the $368 billion-plus it just agreed to. Juries have been seeing contemporary smokers for what they are—people who bought a legal product and knowingly took health risks upon themselves (even while the industry did its best to dissemble). If left to individual courts, including appellate courts, the industry might never have paid a dime.

"We got more than I can ever get in litigation," Christine Gregoire, Washington's attorney general, told me. And the dollars are huge. The present value of Philip Morris's obligation is estimated at $50 billion. That's about half what the company is worth.

So is Big Tobacco a loser? Far from it.

The industry that brought you the Marlboro man and the morning cough earns, in the U.S., $7.7 billion a year pretax. To fund annual payments under the settlement, cigarette prices will rise, within a few years by about 80 cents a pack. So smokers are losers (unless they stop smoking). Nobody knows how many will quit, but it won't be enough to offset the rise in prices. Rough guess: prices up 40%, smoking down 15%. That works out to $1.2 billion a year in lost profits. Throw in interest charges on the big payment that will be due upfront, and manufacturers are out some $2 billion in yearly profits.

However, with tobacco barred from billboards and sporting events and restricted elsewhere, the industry's $6 billion marketing budget will plummet—as it did when tobacco was kicked off the airwaves. Suppose it drops 30%, the estimate of Sanford C. Bernstein & Co.'s Gary Black. Presto, most of its lost profits were just recouped.

What kind of business can raise prices by nearly half, excise a third of its marketing and not miss a beat? Must have a heck of a product (read: an addictive one). Must have low costs, too. Cigarette machines churn out 12,000 butts a minute. You go to a factory and see lots of machines, not many people. But that's not all. Any other business with such fundamentals would attract a ton of competitors. But imagine trying to persuade the board of, say, Johnson & Johnson that it could raise its return by diversifying into tobacco. Fear of liability and social opprobrium act as a protective shield against new entrants.

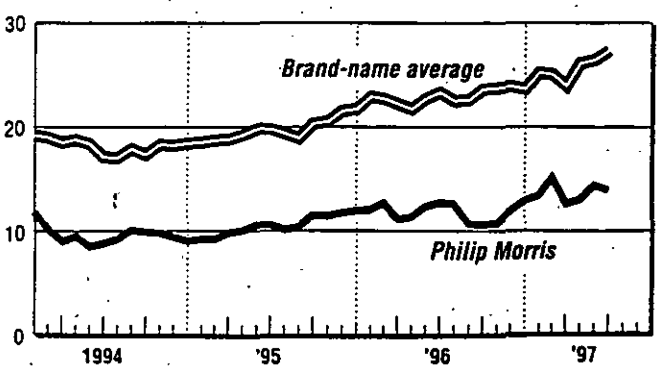
Normally, when there are limited suppliers for a product perceived as necessary, such as electric power, the government holds down prices. But that would stimulate demand. So tobacco is unregulated in price, addictive *and* insulated from new competition. In business, it doesn't get any better.

Philip Morris, the biggest company, has free cash flow of close to $7 billion—about equal to its annual settlement bill from 2002 to eternity. (On an aftertax basis, the bill is smaller.) That annual tab will rise with inflation; however, it will be reduced in line with sales. All in, the amount PM pays will grow very slowly. However, its $7 billion cash flow, which is increasingly fueled by selling cigarettes overseas, is growing at double-digit rates. In time, that cash flow will not merely equal, it will greatly surpass and eventually dwarf the settlement dollars.

The settlement won't (as the industry hopes) remove the tar from its image, but it will get something that profits alone can't buy: a higher price-earnings multiple on Wall Street.

Desperately Seeking a Multiple

Price-earnings multiples of seven brand-name consumer stocks and Philip Morris



Source: Sanford C. Bernstein

Health-minded critics have argued that if tobacco wins, the public must lose. But much as it may hurt to say it, the public interest isn't reducing tobacco profit; it's reducing smoking, particularly among bambinos. According to Bill Novelli, president of Campaign for Tobacco-Free Kids, the single best way to cut into smoking is to make it more expensive. The settlement, pending Congress's approval, will do that.

It also requires states to police the stores. I was dubious whether that would do much until I saw the figures: Sixty percent of the under-18 inhalation set *usually* buy their own. By comparison, it's pretty tough for a 14-year-old to order a dry martini. Cigarette vendors, like bartenders, now will be encouraged to fear loss-of-license and jail time.

Expect less from programs to finance would-be quitters (you got to want to for yourself) and to publicize the non-news that smoking kills. But if sports can sell a $150 rubber shoe, it can sell a pack of smokes. Ending the tie-ins is a good idea.

One more win is that the settlement pushes Congress—the proper venue for resolving long-running national problems—to act. Before it throws tobacco back to 1,000 courts, where results are unlikely, it ought to think about that.

THE WALL STREET JOURNAL
THURSDAY, JULY 3, 1997