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U.S. Department of Agriculture
Agricultural Outlook Forum 1998
February 23 & 24, 1998

Trends in the Global Tobacco Industry & the
US Tobacco Settlement

Farrell Delman

TRENDS IN THE GLOBAL TOBACCO INDUSTRY & THE US TOBACCO SETTLEMENT



Farrell Delman
President, TMA

Japan Tobacco Inc.

January 19, 1998

Global Trends

- Product Trends
- Financial Trends
- US Tobacco Settlement & Public Policy Trends
- Emerging Issues and Products

Global Trends

■ Product Trends

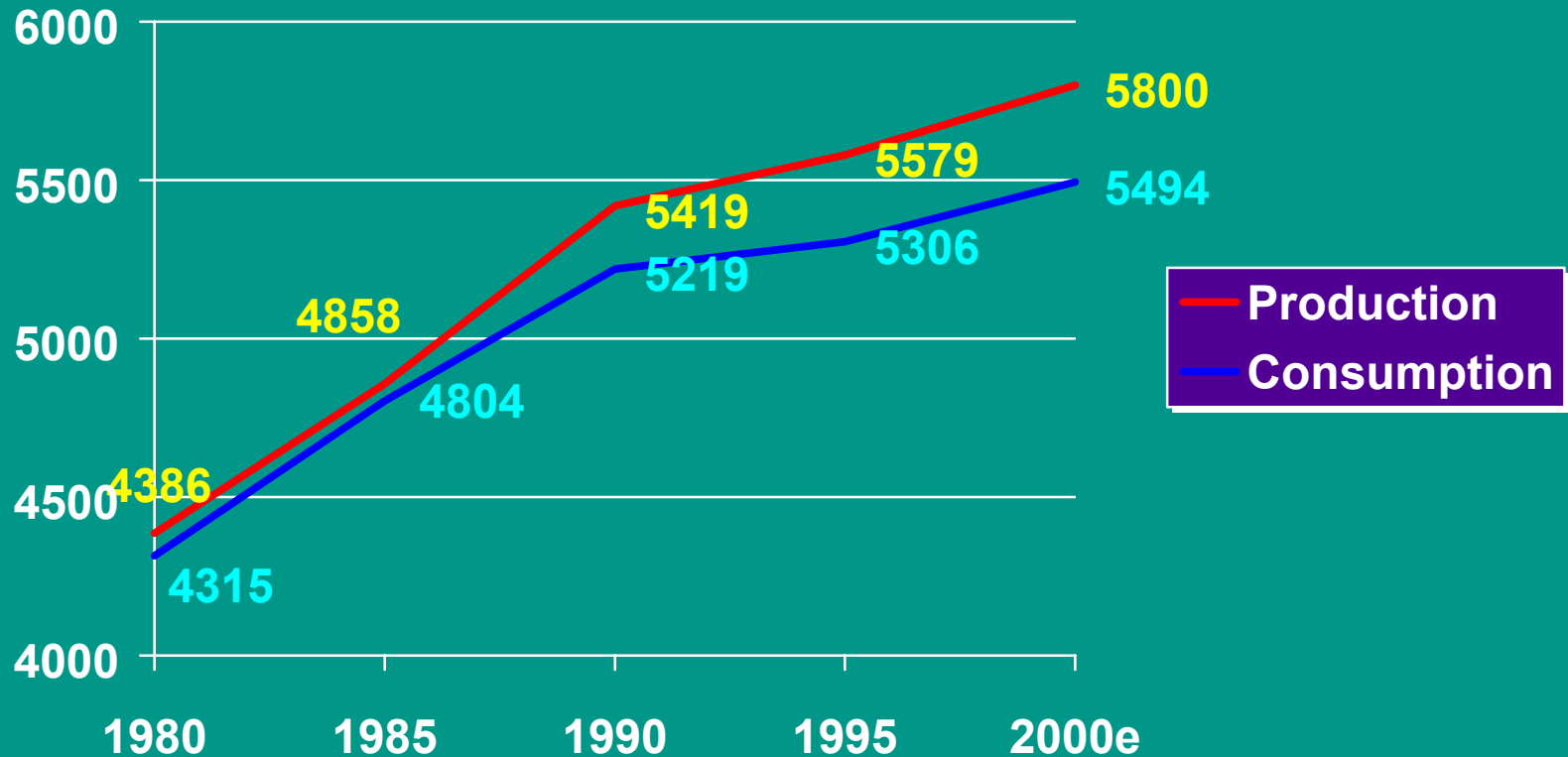
Cigarettes / American Blend

Cigars

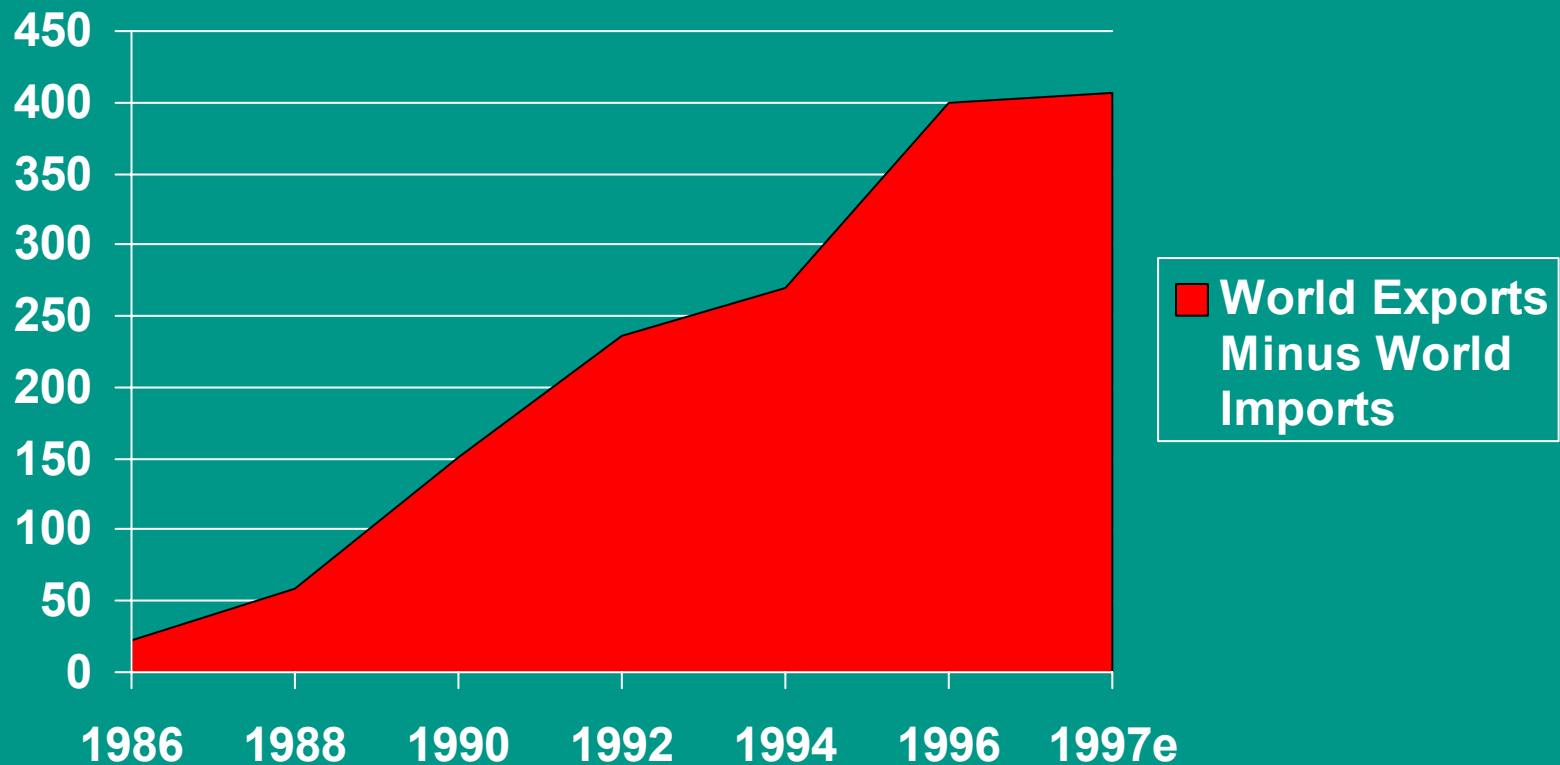
Other Tobacco Products

Leaf

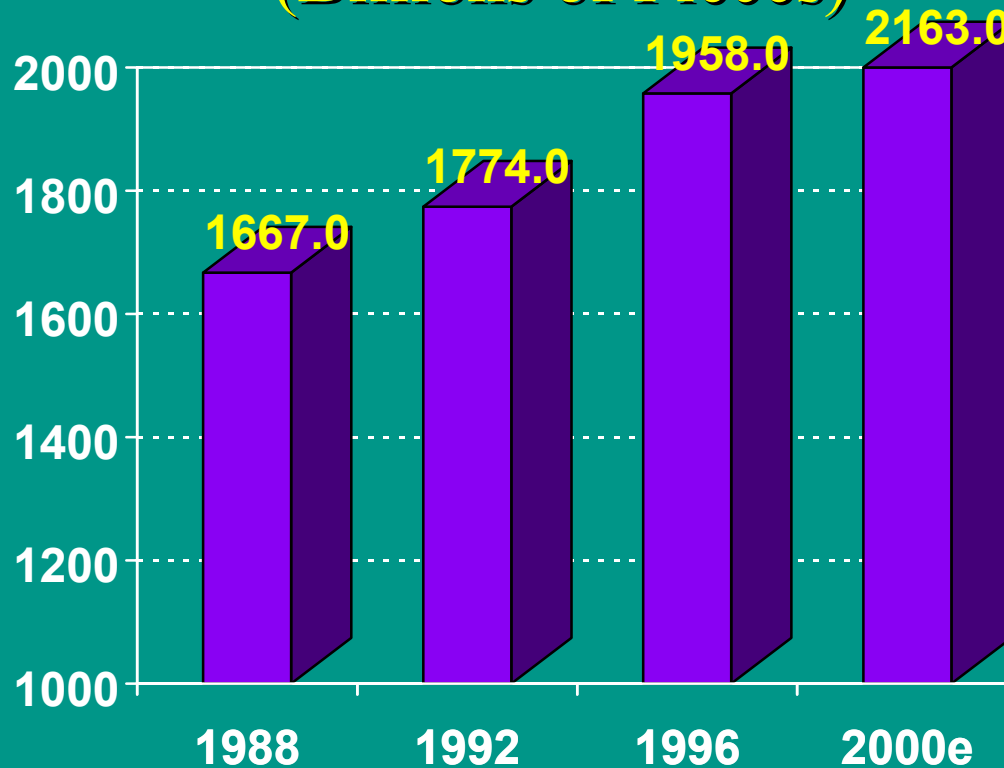
World Cigarette Production vs. Consumption (Billions of Pieces)



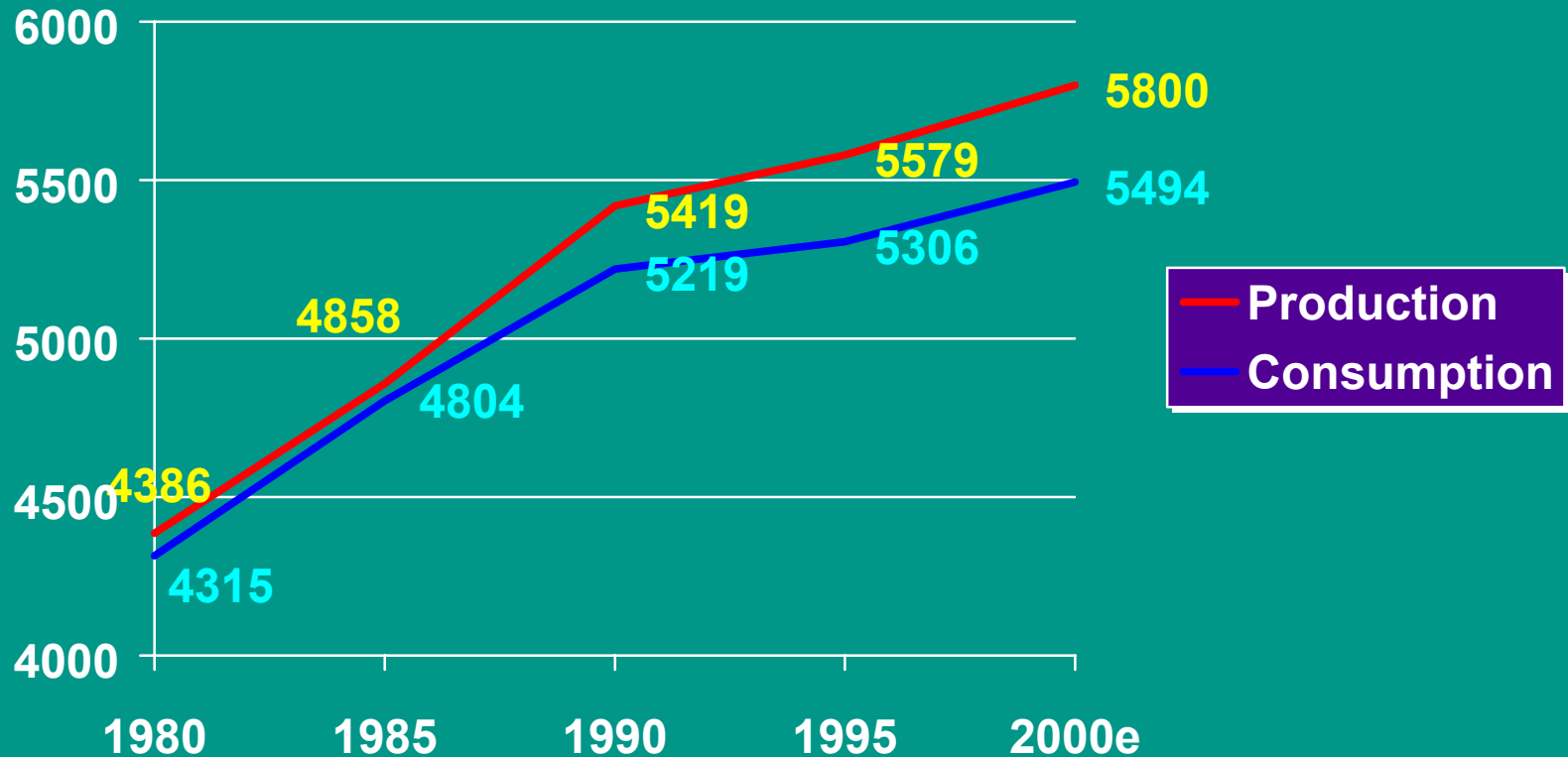
The Advent of Worldwide Cigarette Smuggling (Billions of Pieces)

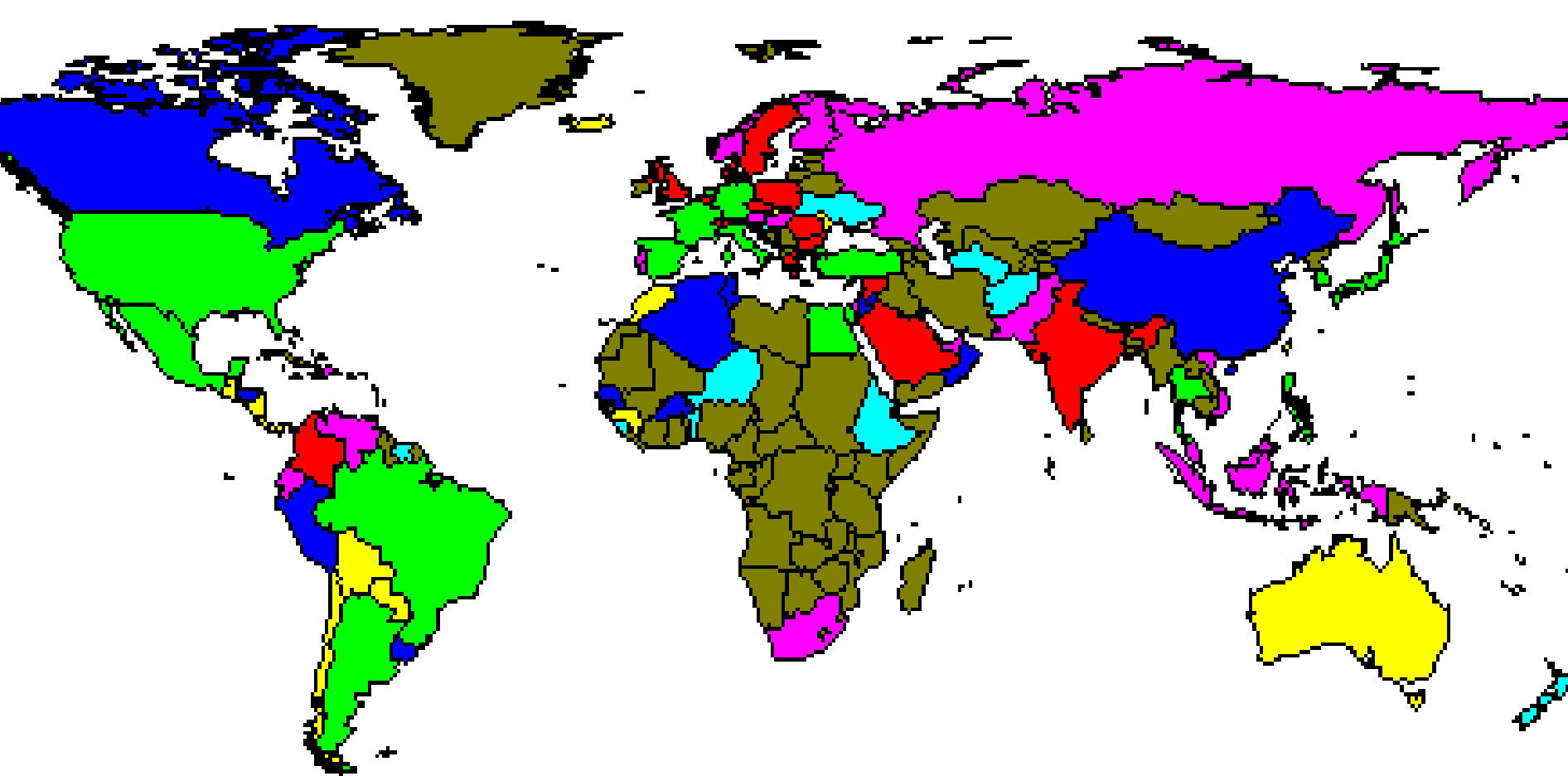


World American-Blend Cigarette Consumption (Billions of Pieces)



World Cigarette Production vs. Consumption (Billions of Pieces)





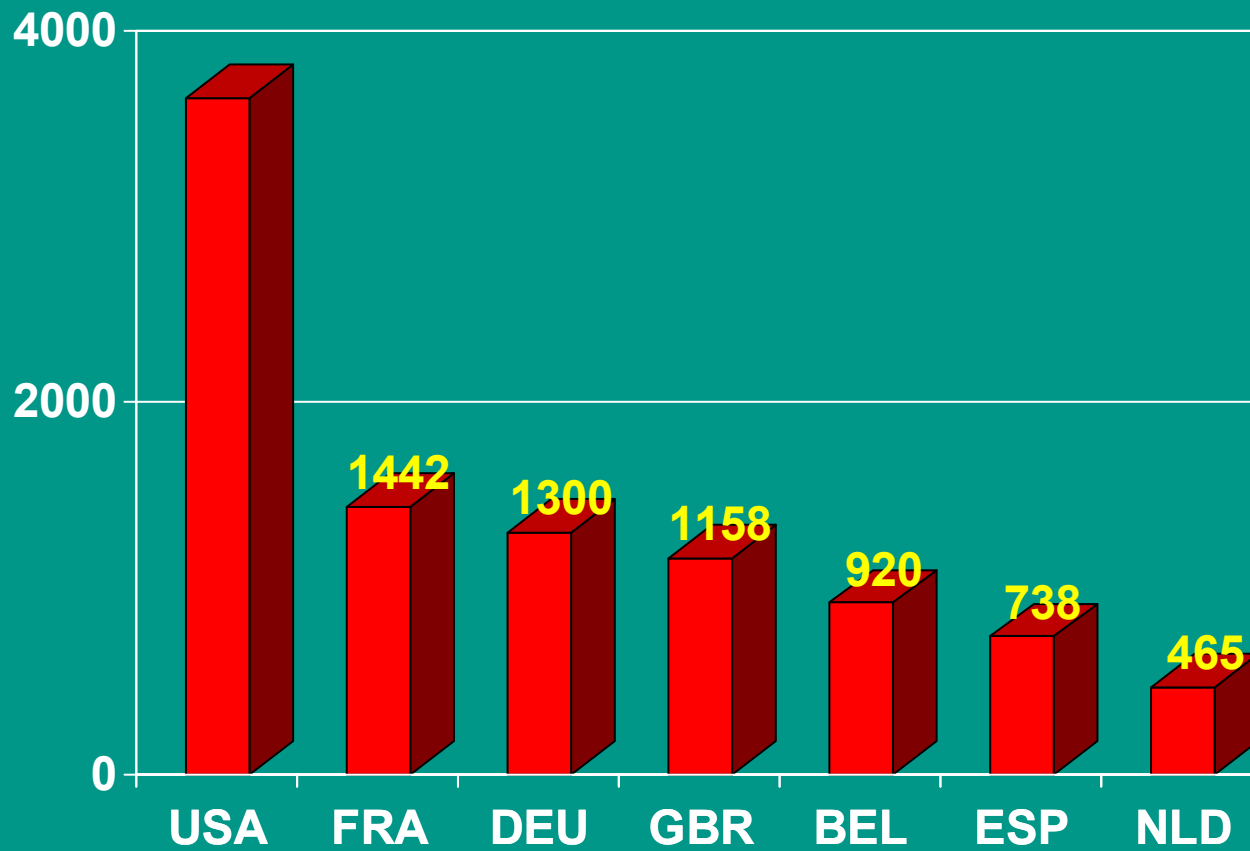
World American-Blend Cigarette Consumption - 1996

Over 22.4 billion pieces consumed.

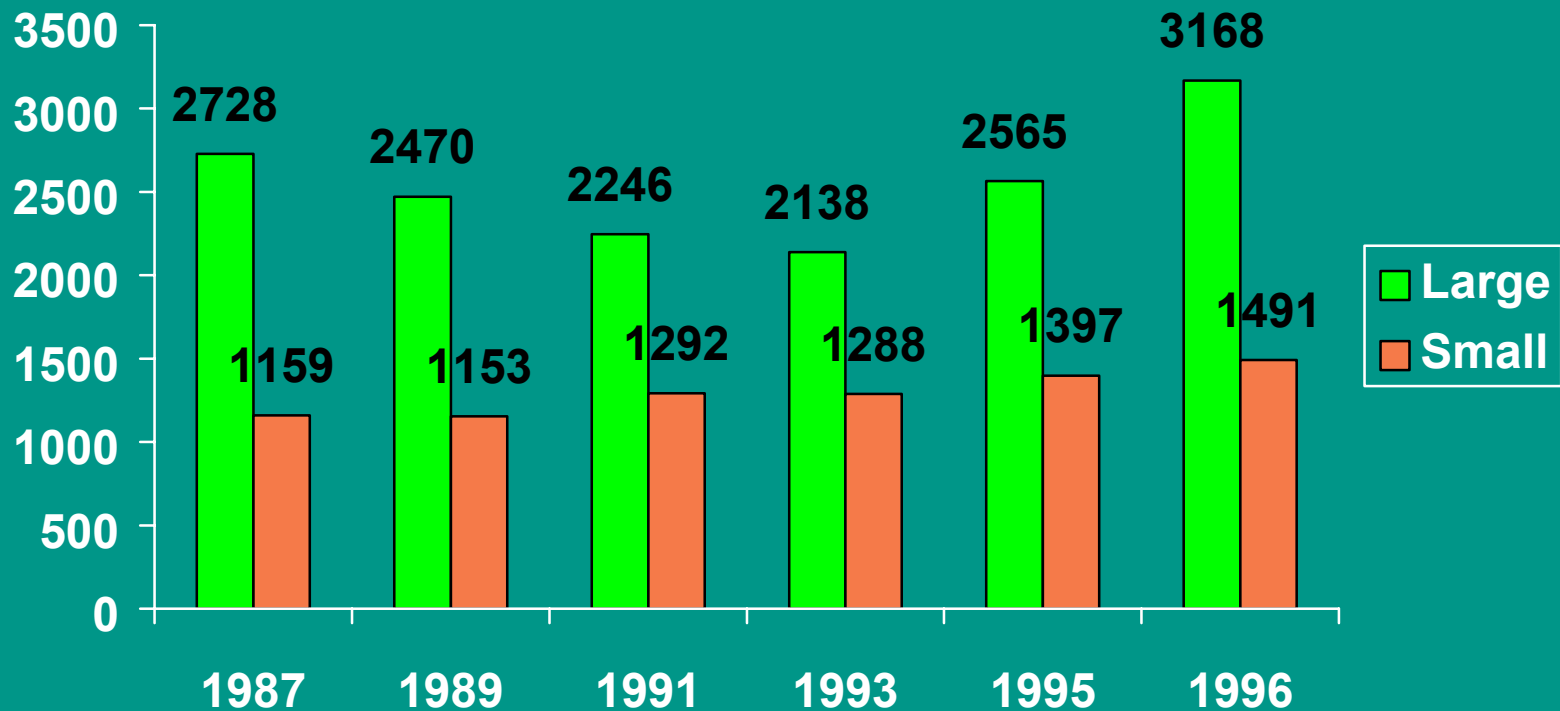
Between 6.6 and 22.4 billion pieces consumed.

Between 2.6 and 6.6 billion pieces consumed.

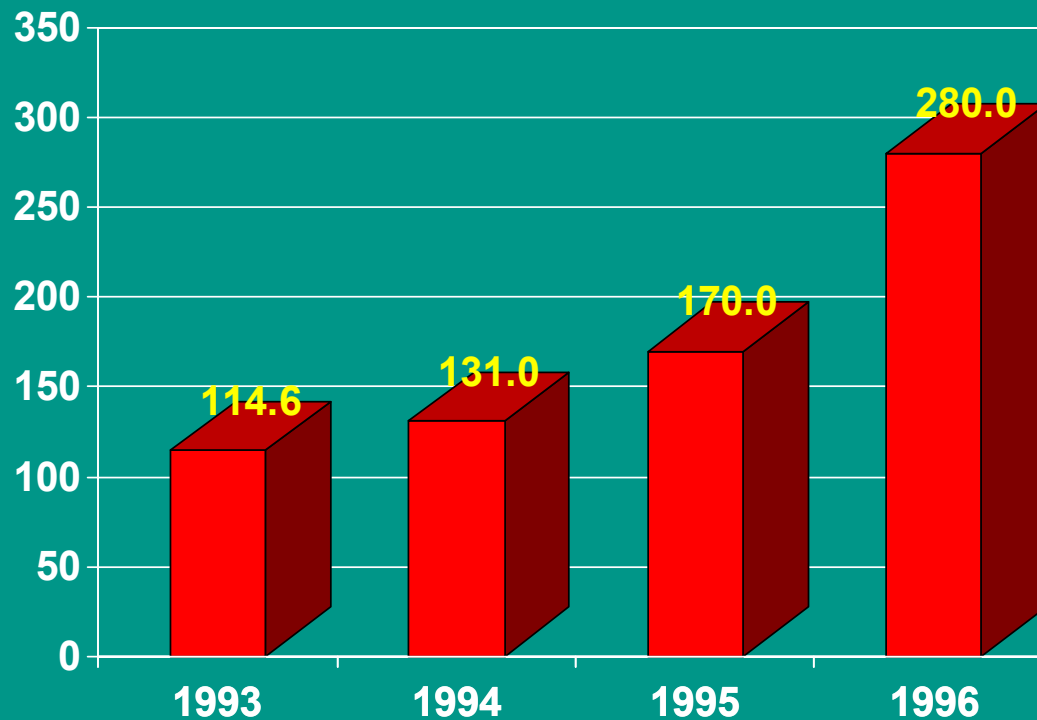
Leading World Cigar Consumers - 1995 (millions of pieces)



U.S. Cigar Consumption by Type (Millions of Pieces)



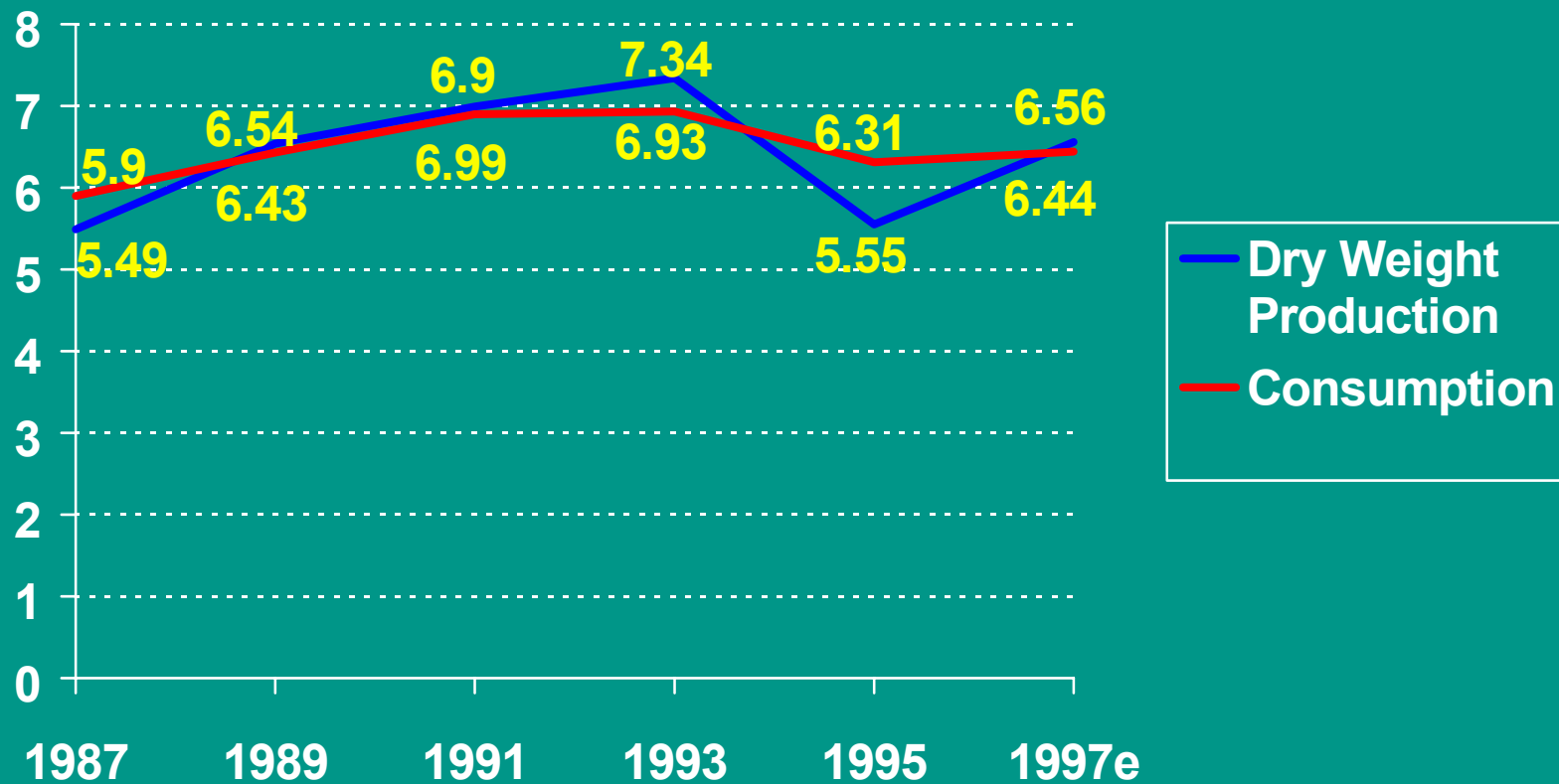
US Premium Cigar Sales, 1996 (millions of pieces)



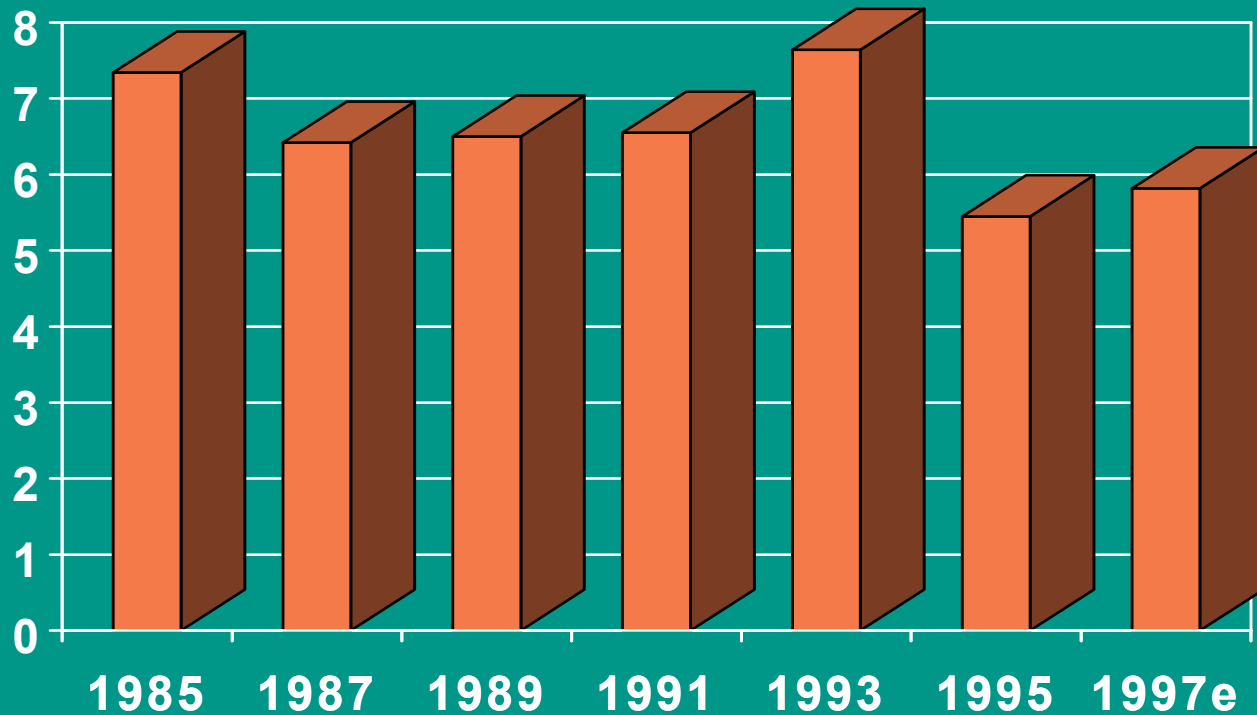
Countries Around the World That Have Banned Smokeless Tobacco Products

- Afghanistan
- Australia
- Austria
- Belgium
- Denmark
- Finland
- France
- Germany
- Greece
- Hong Kong
- Ireland
- Italy
- Lithuania
- Luxembourg
- Mauritius
- Netherlands
- New Zealand
- Portugal
- Spain
- Switzerland
- Thailand
- United Arab Emirates
- United Kingdom

World Tobacco Leaf Production and Consumption (Mns. of metric tons)

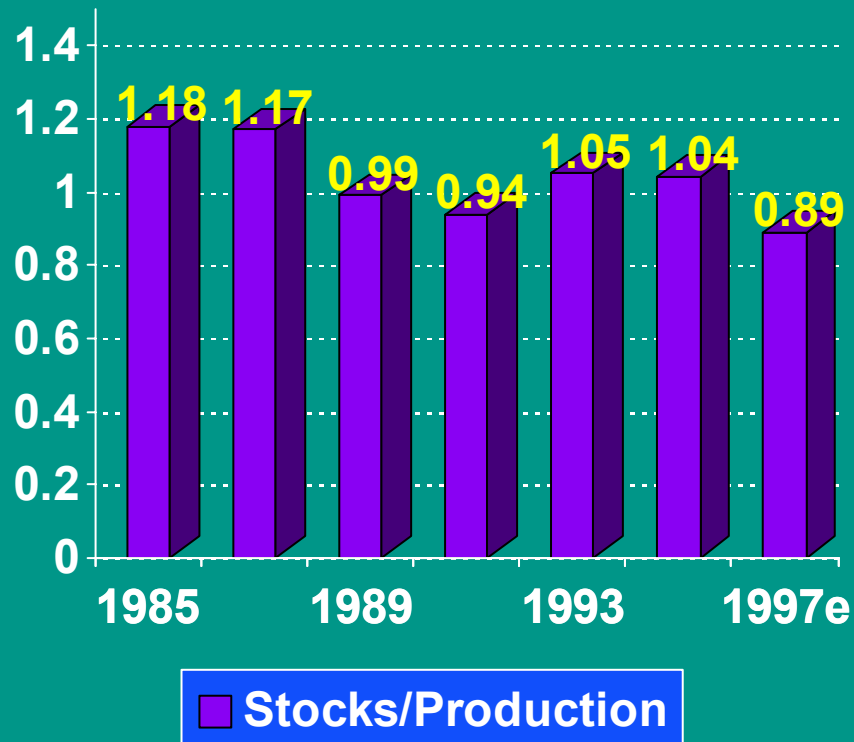


World Leaf Tobacco Year End Stocks (Millions of metric tons)



World Leaf Production vs. Stocks

(Millions of metric tons)



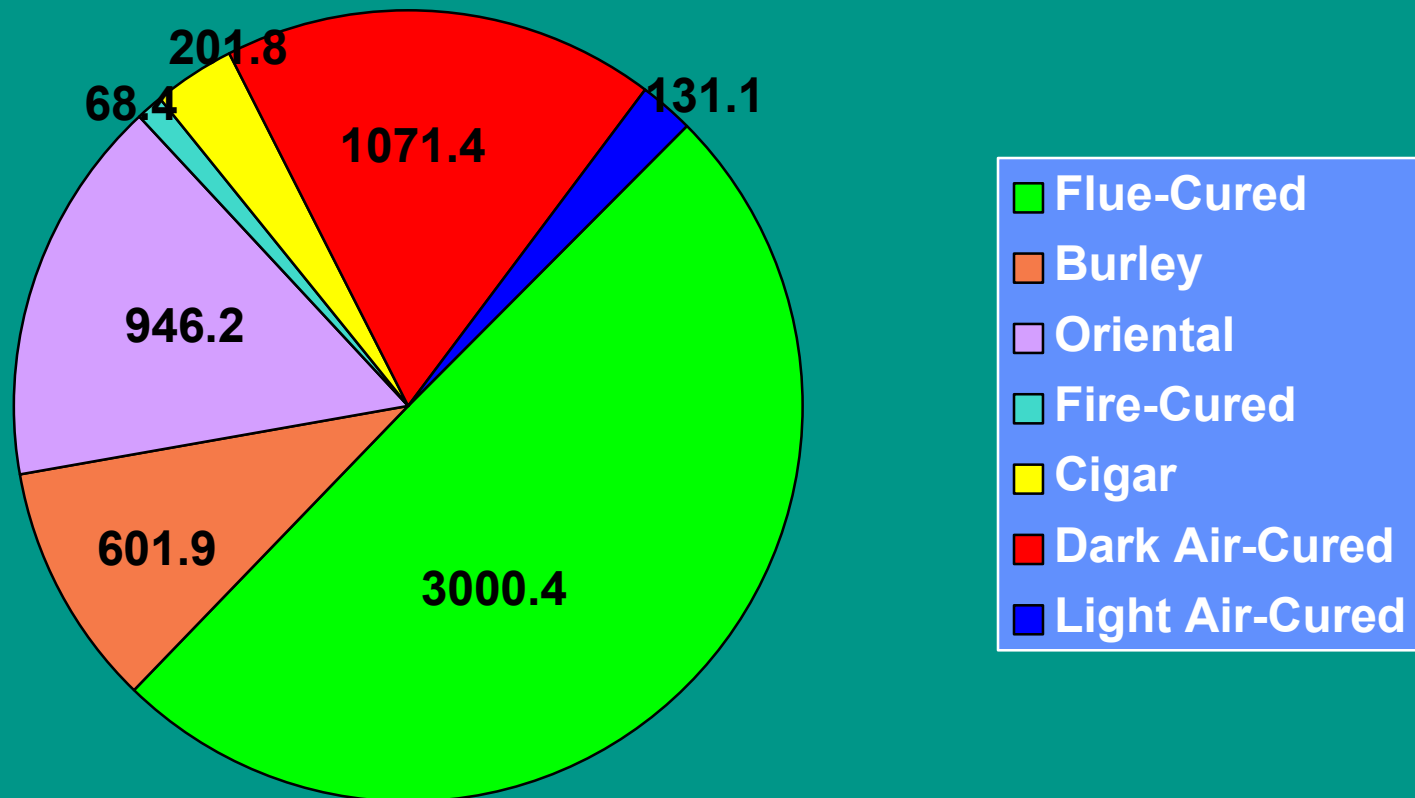
What is an American-Blend cigarette?

Breakdown of Tobacco Content
(All tobacco types are light except for Oriental)

■ Flue-Cured	45-55%
■ Burley	25-35%
■ Light Air-Cured	1-3%
■ Oriental	10-25%

World Leaf Production By Type - 1986

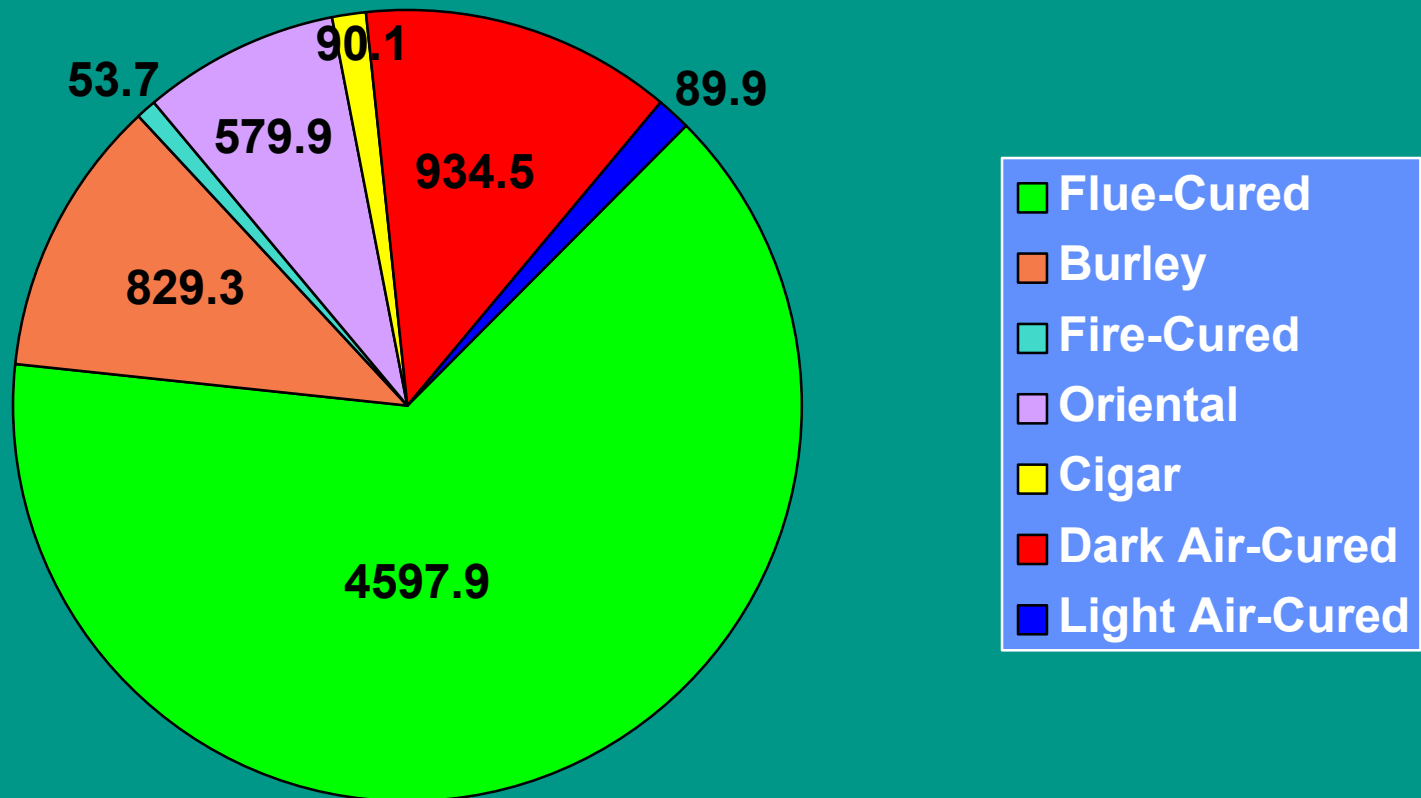
(Figures are in Thousands of Metric Tons)



The world produced 6,021,200 metric tons of leaf in 1986.

World Leaf Production By Type - 1996

(Figures are in Thousands of Metric Tons)



The world produced 7,175,429 metric tons of leaf in 1996.

Global Trends

- **Product Trends**
- **Financial Trends**

Globalization

Consolidation

Privatization

World Leaf Dealer Consolidation

Universal Inc.

- 8/97 - Acquired the oriental leaf operations of Socotab.
- 7/97 - Acquired the tobacco processing operations of the Polish unit of Reemtsma Cigarettenfabriken.
- 1/96 - Agreement with Shanghai Tobacco Group and Bengbu Tobacco Redrying Co. to start a new leaf processing plant in China's Anhui Province in which Universal is to purchase all leaf production.
- 10/95 - Canadian subsidiary, Simcoe Leaf, to acquire all leaf operations for RJR-MacDonald.
- 8/93 - Acquisition of Hungarian based Nyidofer Tobacco Processing Co.

World Leaf Dealer Consolidation

DIMON

- 4/97 - Acquisition of Intabex Holdings Worldwide.
- 5/95 - Agreement with Yunnan Leaf Tobacco Co. and China Tobacco Import Export Yunnan Corp. (both part of CNTC) for the construction of a new leaf tobacco processing facility.
- 4/95 - Acquisition of Austria Tabakwerke's leaf operations and Austria Tabak Einkaufs & Handelorganisation's tobacco leaf operations in Greece, Turkey and Bulgaria.
- 4/95 - Merger of Dibrell Brothers and Monk-Austin into a new company DIMON.

Matrix of Who's Who by Size and Degree of Internationalization

(Global 3, Size 1)	(Global 3, Size 2)	(Global 3, Size 3)
None	R.J. Reynolds (US) Rothmans (UK)	British American Tobacco (UK) Philip Morris (US)
(Global 2, Size 1)	(Global 2, Size 2)	(Global 2, Size 3)
Austria Tabakwerke (Austria) House of Prince (Denmark) Karelia (Greece) Liggett - Ducat (Russia) Swedish Match (Sweden) Tabacalera (Spain) TEKEL (Turkey)	Reemtsma (Germany) Gallaher (UK) Imperial (UK) SEITA (France)	Japan Tobacco (Japan)
(Global 1, Size 1)	(Global 1, Size 2)	(Global 1, Size 3)
Coltobaco, Protabaco (Colombia) DUBEK (Israel) Khyber / Souviner (Pakistan) Nanyang Brothers (HK) Tiedemanns (Norway)	Eastern Tobacco (Egypt) Fortune Tobacco (Philippines) Korea Tobacco & Ginseng Lorillard (US) Monopoli di Stato (Italy) TTWMB (Taiwan) TTM (Thailand)	China National Tobacco Corp

Cigarette Companies with Largest International Presence

Global 3, Size 1
None

Global 3, Size 2
R.J. Reynolds (US)
Rothmans (UK)

Global 3, Size 3
British American Tobacco (UK)
Philip Morris (US)

Tobacco Companies with Significant International Presence and/or FDI

Global 2, Size 1

Austria Tabakwerke (Austria)
House of Prince (Denmark)
Karelia Brothers (Greece)
Liggett (Ducat) (Moscow)
Swedish Match (Sweden)
Tabacalera (Spain)
Tekel (Turkey)

Global 2, Size 2

Gallaher (UK)
Imperial (UK)
Reemtsma (Germany)
SEITA (France)

Global 2, Size 3

Japan Tobacco (Japan)

Tobacco Companies with No Significant International Presence

Global 1, Size 1

Coltobaco (Colombia), Protabaco (Colombia),
Dubek (Israel), Khyber / Souviner (Pakistan),
Nanyang Brothers (HK), Tiedemanns (Norway)

Global 1, Size 2

Eastern Tobacco (Egypt), Fortune Tobacco
(Philippines), Korea Tobacco & Ginseng Corp.,
Lorillard (US), Monopoli di Stato (Italy), TTWMB
(Taiwan), TTM (Thailand)

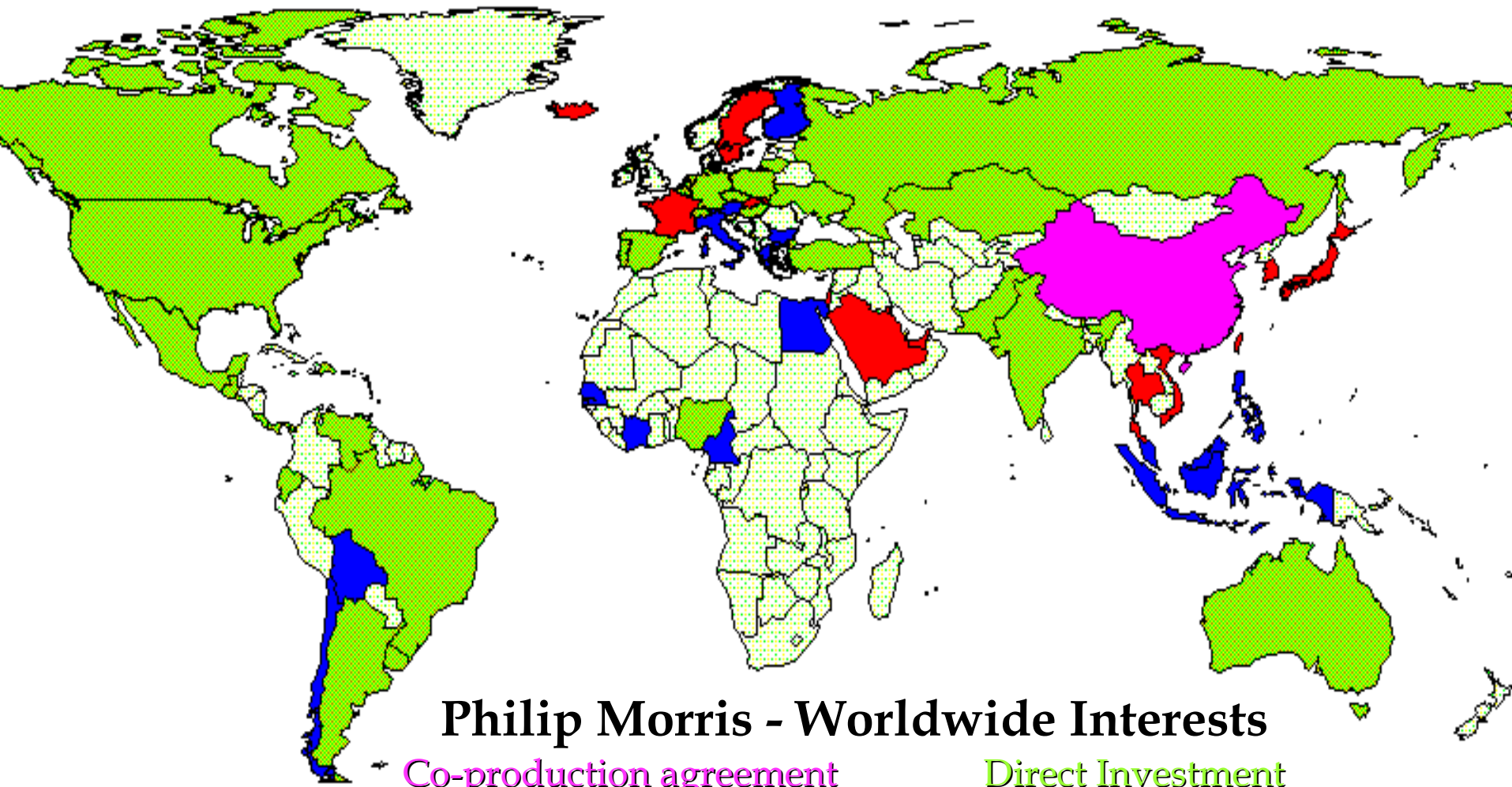
Global 1, Size 3

China National Tobacco Corp.

Factories Acquired by Philip Morris Since 1990

1. Dresden (East Germany) - 4/90
2. Eger (Hungary) - 11/91
3. Samara (Russia) - 12/91
4. Tabak (Czech Republic) - 4/92
5. Klaipeda (Lithuania) - 3/93
6. Krasnodar (Russia) - 6/93
7. Almaty (Kazakhstan) - 9/93
8. Kharkov (Ukraine) - 2/94
9. ZPT-Krakow (Poland) - 1/96

Note: PM has also built a cigarette factory in St.
Petersburg, Russia.



Philip Morris - Worldwide Interests

Co-production agreement

Major export market

Licensing agreement

Direct Investment

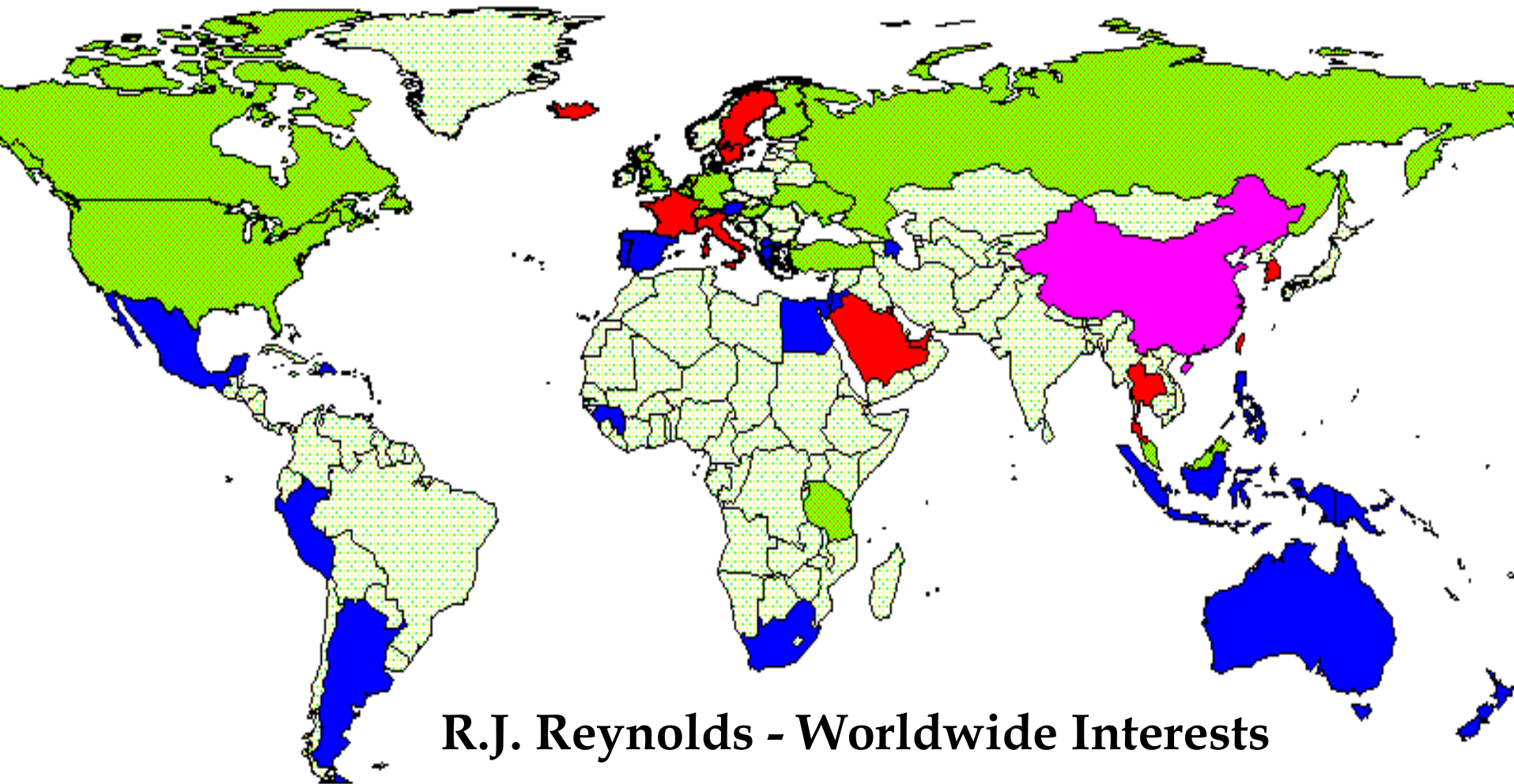
Little or no exports

Factories Acquired by RJR

Since 1990

1. Berlin (Former East Germany) - 7/90
2. Satoraljaújhely (Hungary) - 6/92
3. St. Petersburg (Russia) - 7/92
4. Lviv (Ukraine) - 9/92
5. Kremenchuk (Ukraine) - 9/92
6. Armavir (Russia) - 11/94
7. Yelets (Russia) - 9/95
8. Baku (Azerbaijan) - 10/96

Note: RJR has also built cigarette factories in the Czech Republic, Romania, Poland, Kazakhstan, and a second facility in St. Petersburg, Russia.



R.J. Reynolds - Worldwide Interests

Co-production agreement

Major export market

Licensing agreement

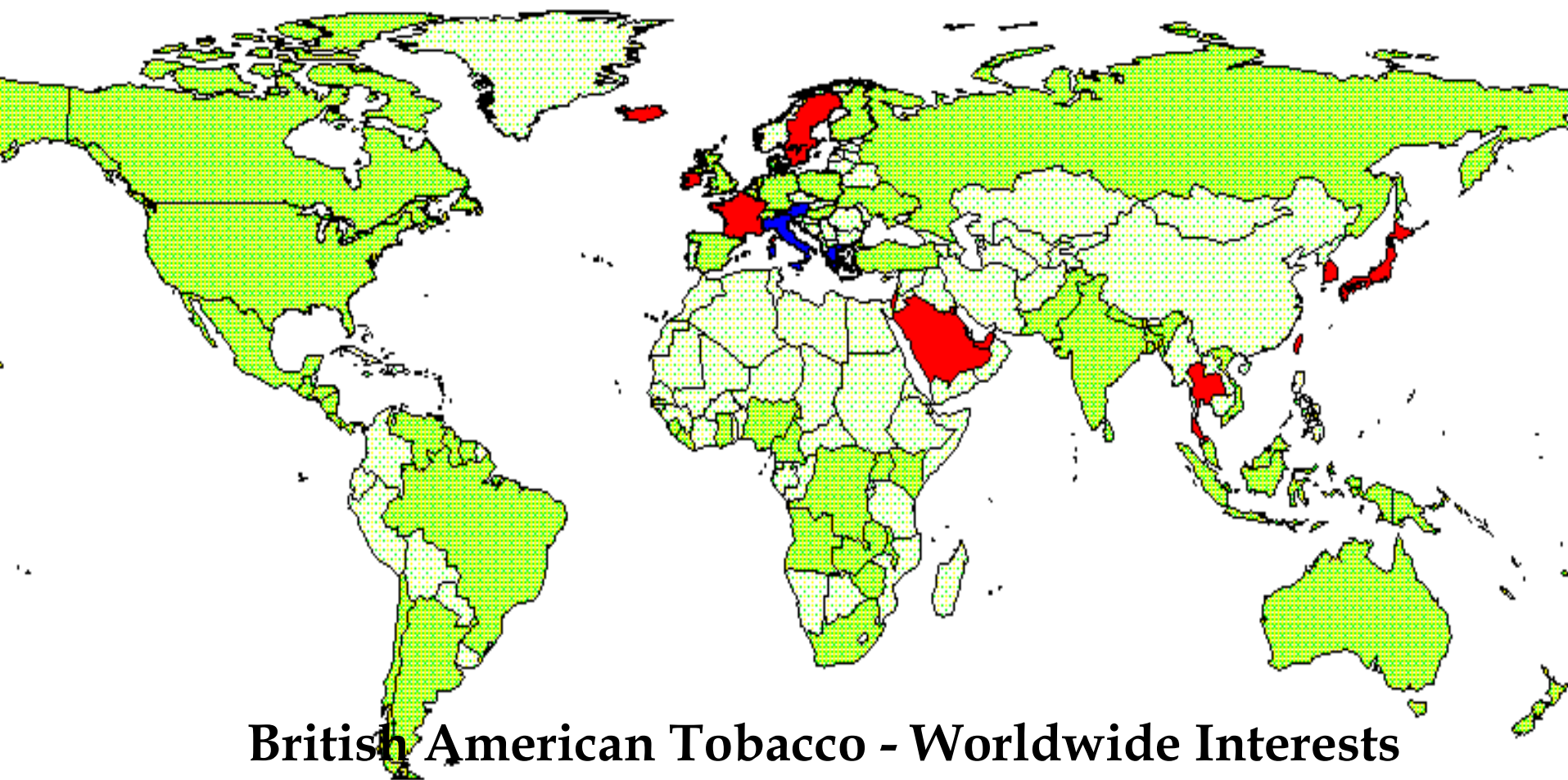
Direct Investment

Little or no exports

Factories Acquired by British American Tobacco Since 1990

1. Pecs (Hungary) - 12/91
2. Prilucky (Ukraine) - 3/93
3. Saratov (Russia) - 4/94
4. Tashkent (Uzbekistan) - 5/94
5. Yava (Russia) - 11/94
6. Augustow (Poland) - 11/95
7. TEKEL - (Turkey: Co-Production) - 1/98

Note: BAT has also built a cigarette factory in Romania.



British American Tobacco - Worldwide Interests

Major export market

Direct Investment

Licensing agreement

Little or no exports

Factories Acquired by Reemtsma Since 1990

1. Tobakkombinat (Former East Germany) - 7/90
2. Tobacna Tovarna (Slovenia) - 10/91
3. Debrecen (Hungary) - 3/92
4. CSPI (Slovakia) - 4/92
5. Cherkassy (Ukraine) - 11/93
6. Tyutynova (Ukraine) - 2/94
7. WWT Poznan (Poland) - 1/96

Note: Reemtsma is also making an additional \$63 mn investment in Poland to produce 15 bn units.

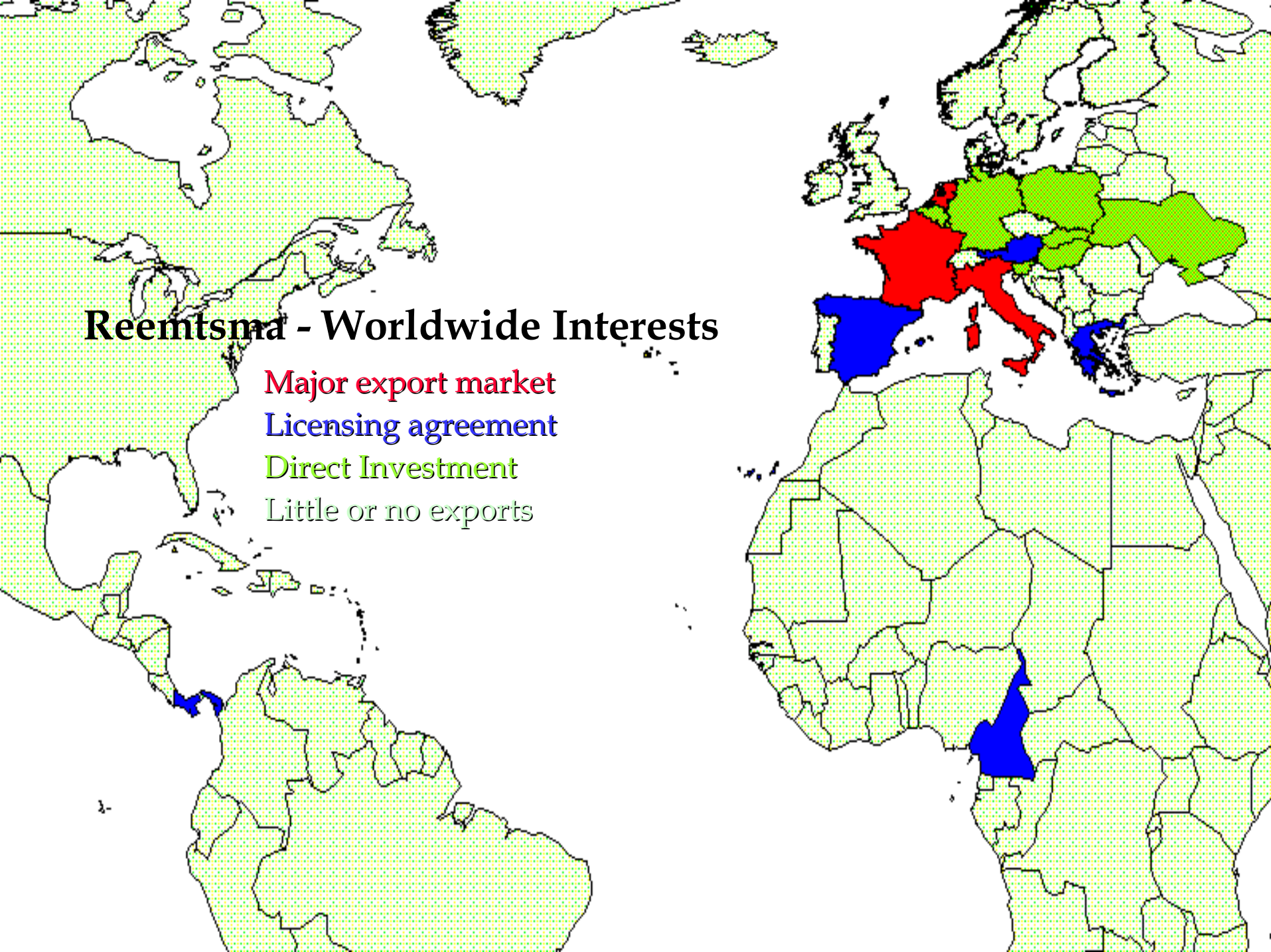
Reemtsma - Worldwide Interests

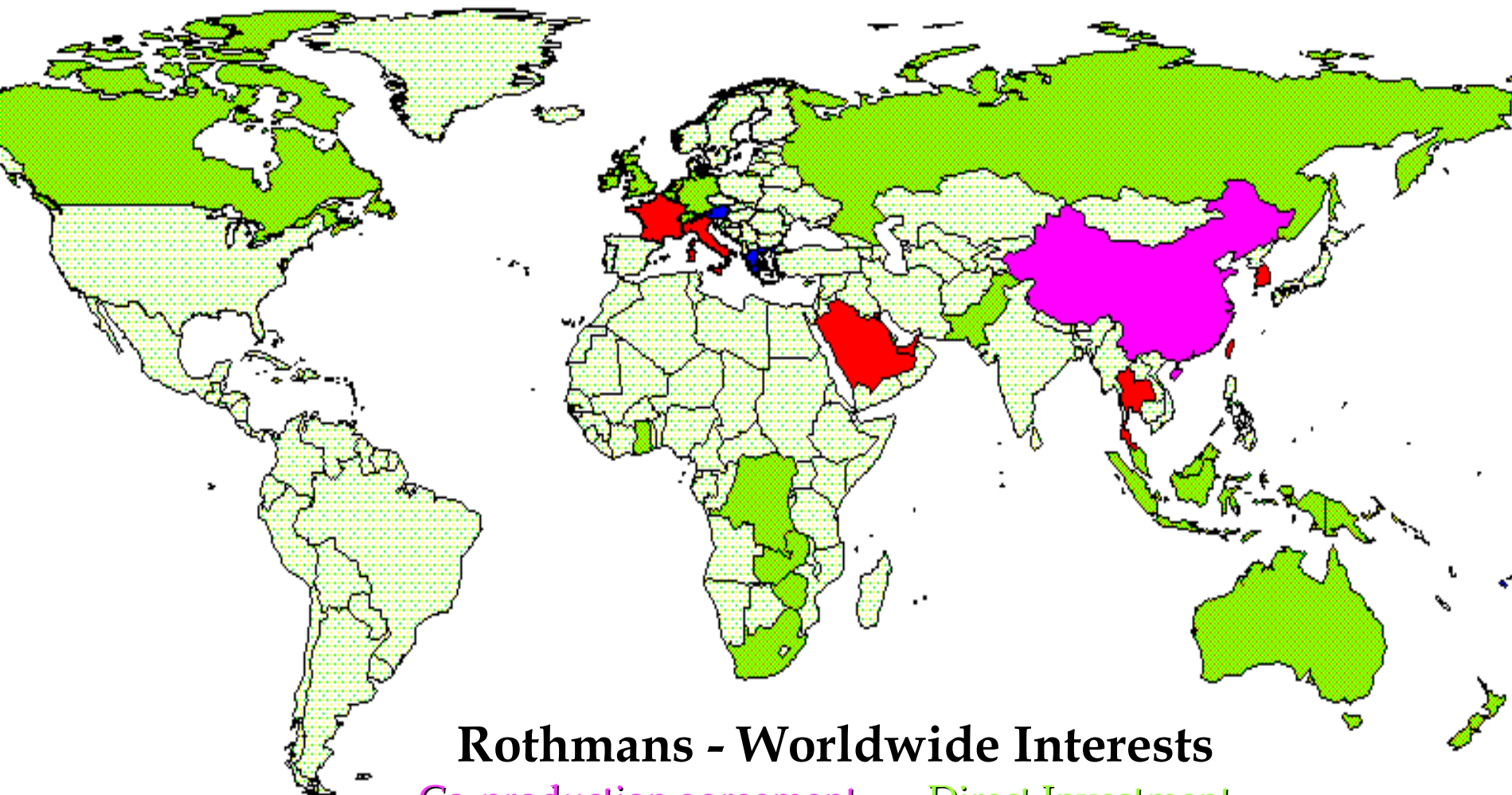
Major export market

Licensing agreement

Direct Investment

Little or no exports





Rothmans - Worldwide Interests

Co-production agreement

Major export market

Licensing agreement

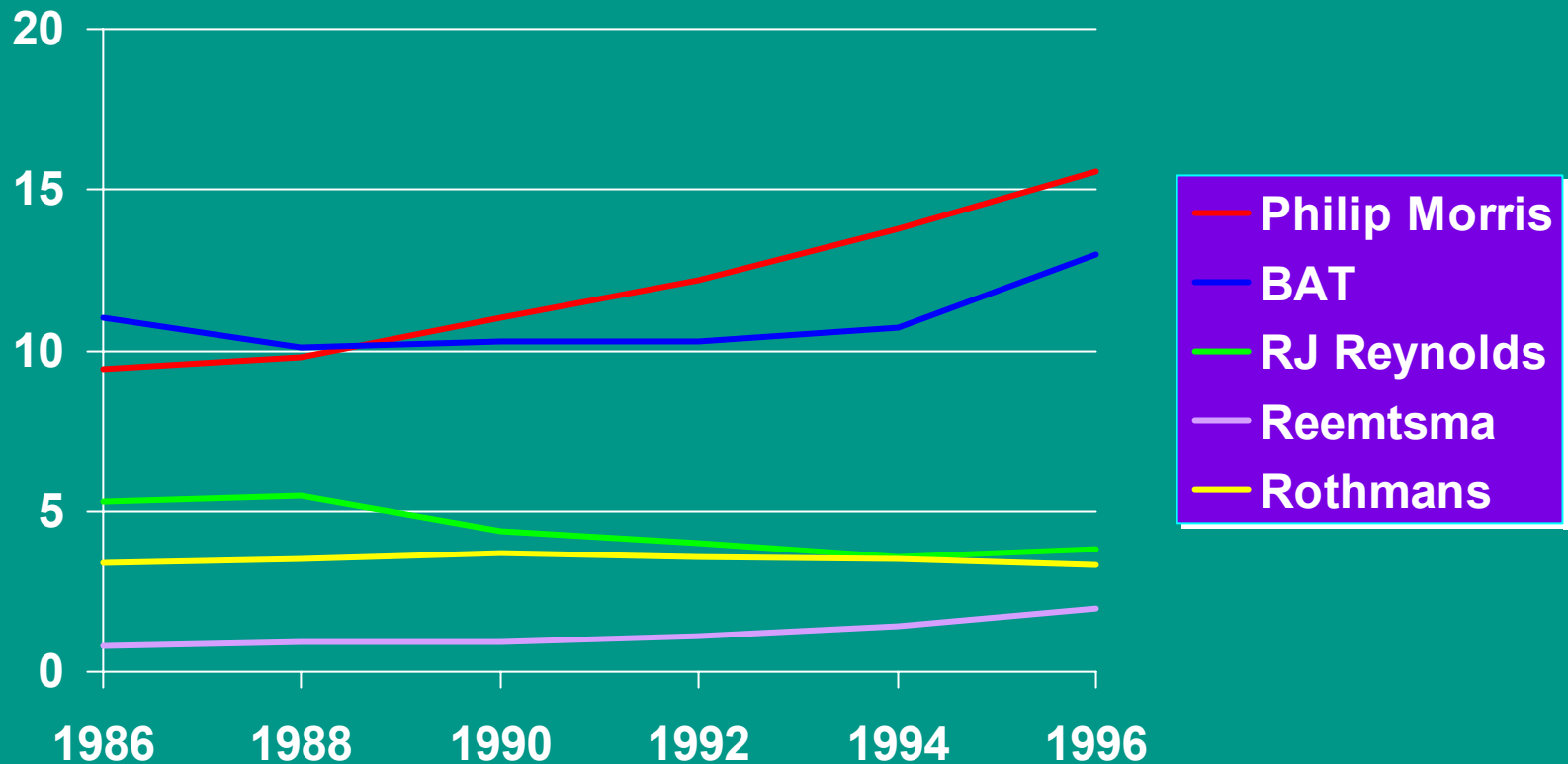
Direct Investment

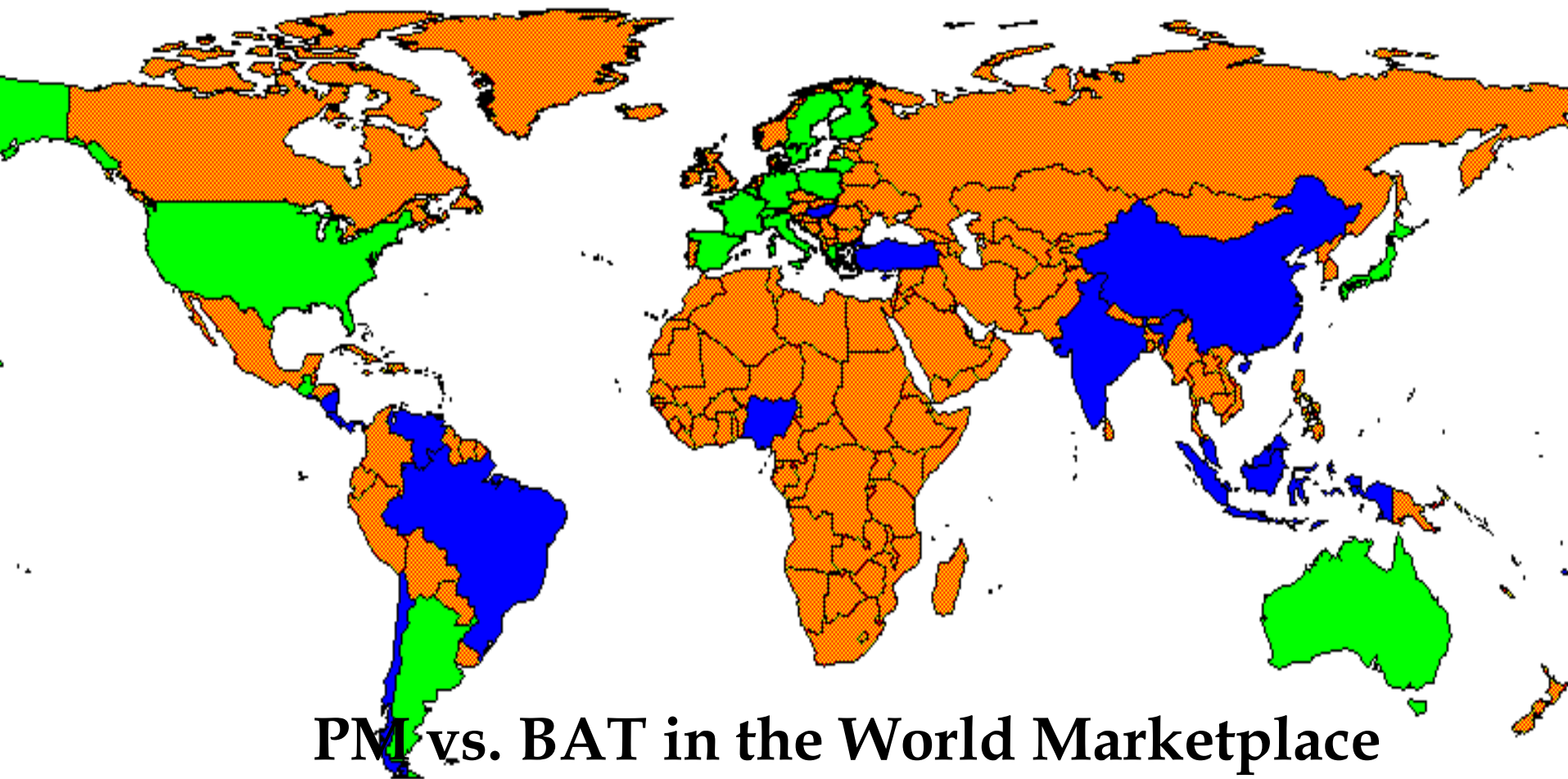
Little or no exports

State Tobacco Enterprises That Have Recently Privatized

- East Germany - 1990
- Hungary - 1991
- Russia - 1991-present
- Slovenia - 1991
- Czech Republic - 1992
- Slovakia - 1992
- Latvia - 1992
- Ukraine - 1992
- Lithuania - 1993
- Estonia - 1993
- Kazakhstan - 1993
- Uzbekistan - 1994
- Japan - 1994 (First 1/3)
- France - 1995
- Poland - 1995
- Azerbaijan - 1996
- Portugal - 1997

Multinational Cigarette Company Market Shares (% of world market)





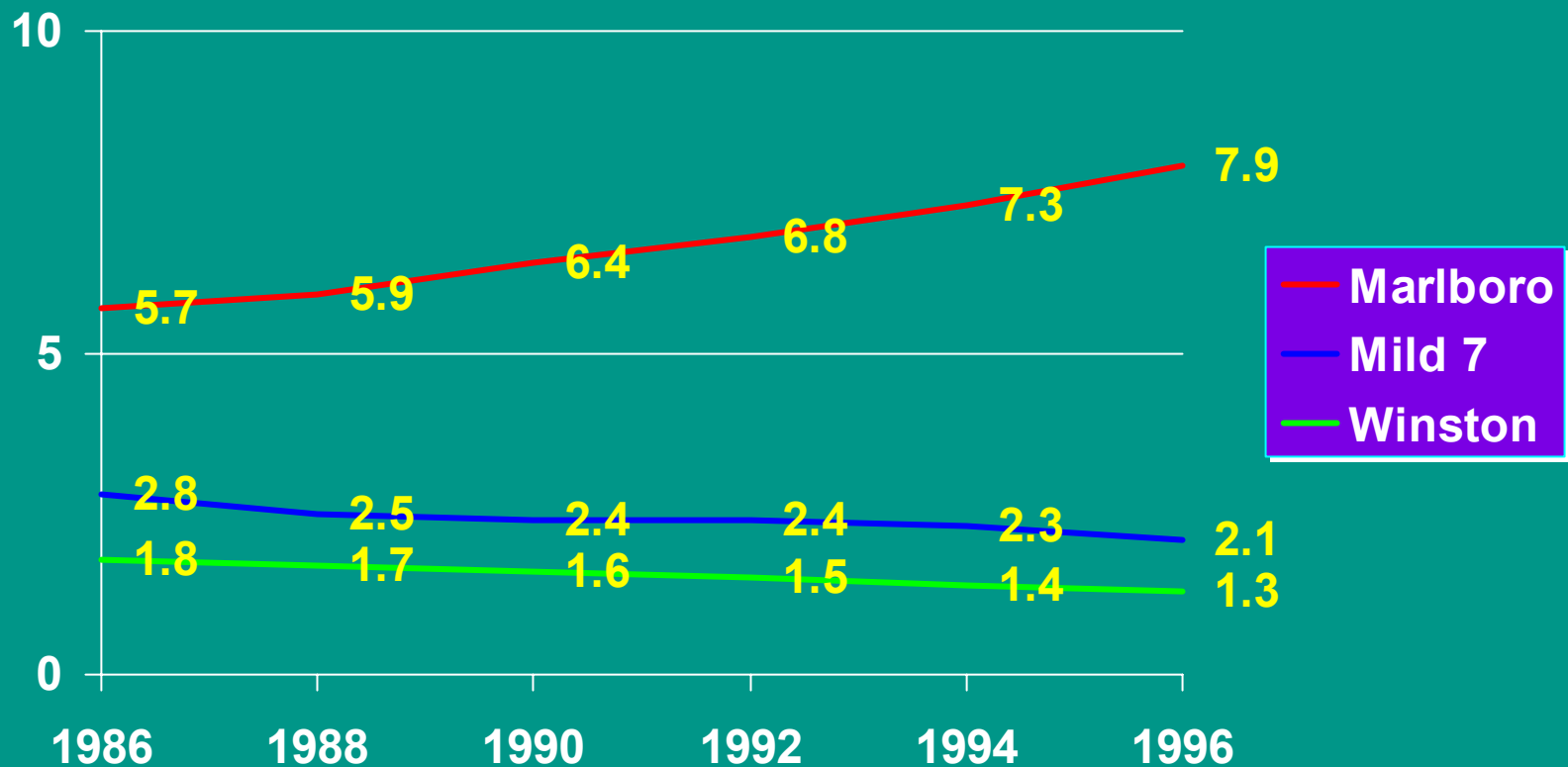
PM vs. BAT in the World Marketplace

Countries where Philip Morris holds a larger market share than BAT.

Countries where BAT holds a larger market share than Philip Morris.

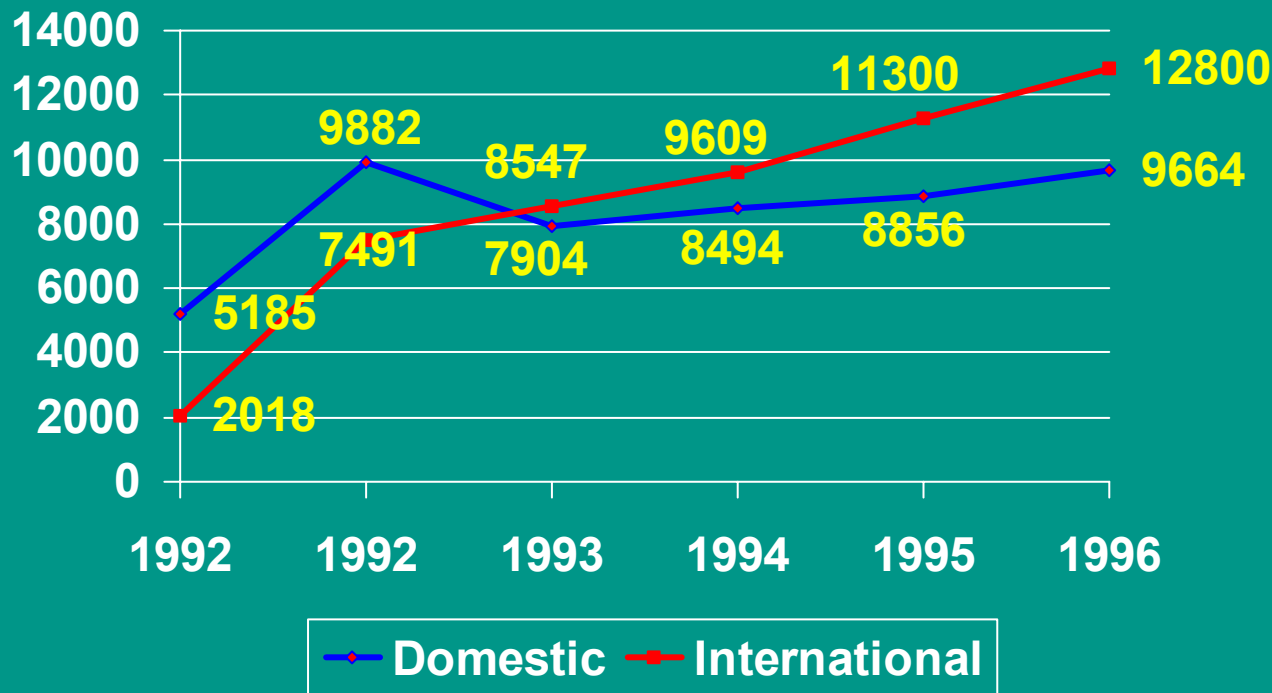
Countries where Philip Morris and BAT do not compete other than a small amount of imports.

International Cigarette Brand Market Shares (% of world market)



Domestic vs. International Sales - Philip Morris

(Figures are in millions of dollars)



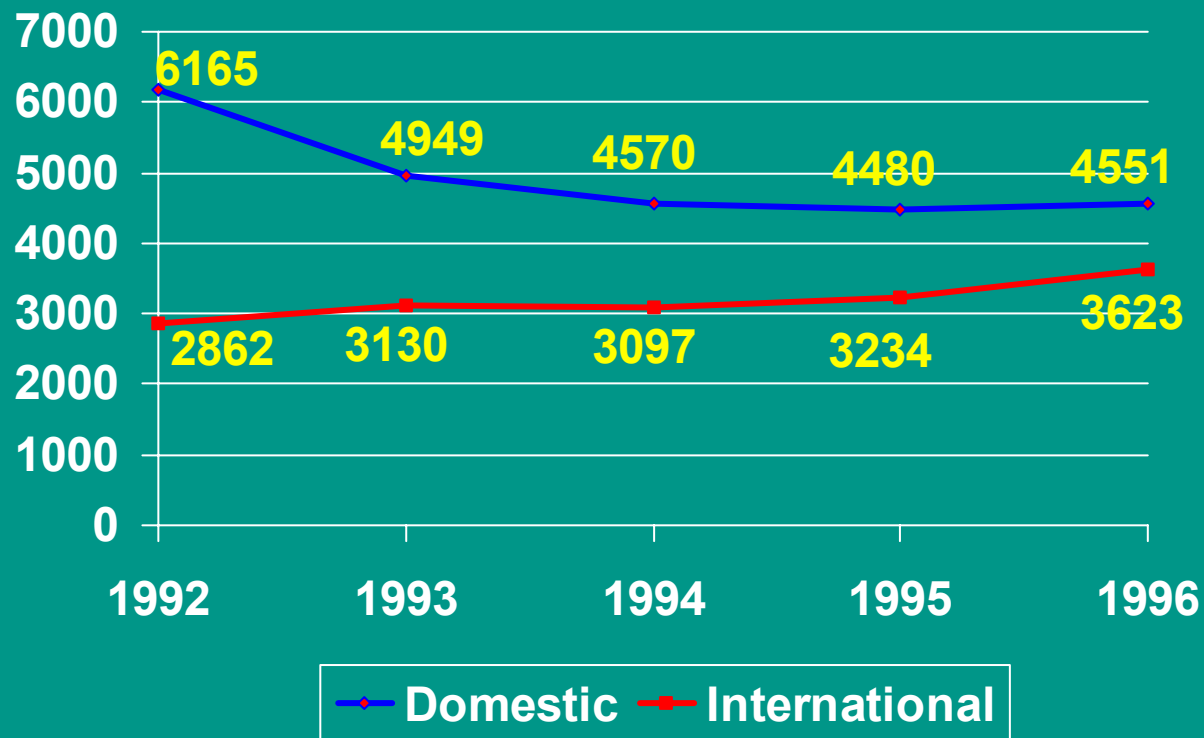
Domestic vs. International Operating Profit - Philip Morris

(Figures are in millions of dollars)



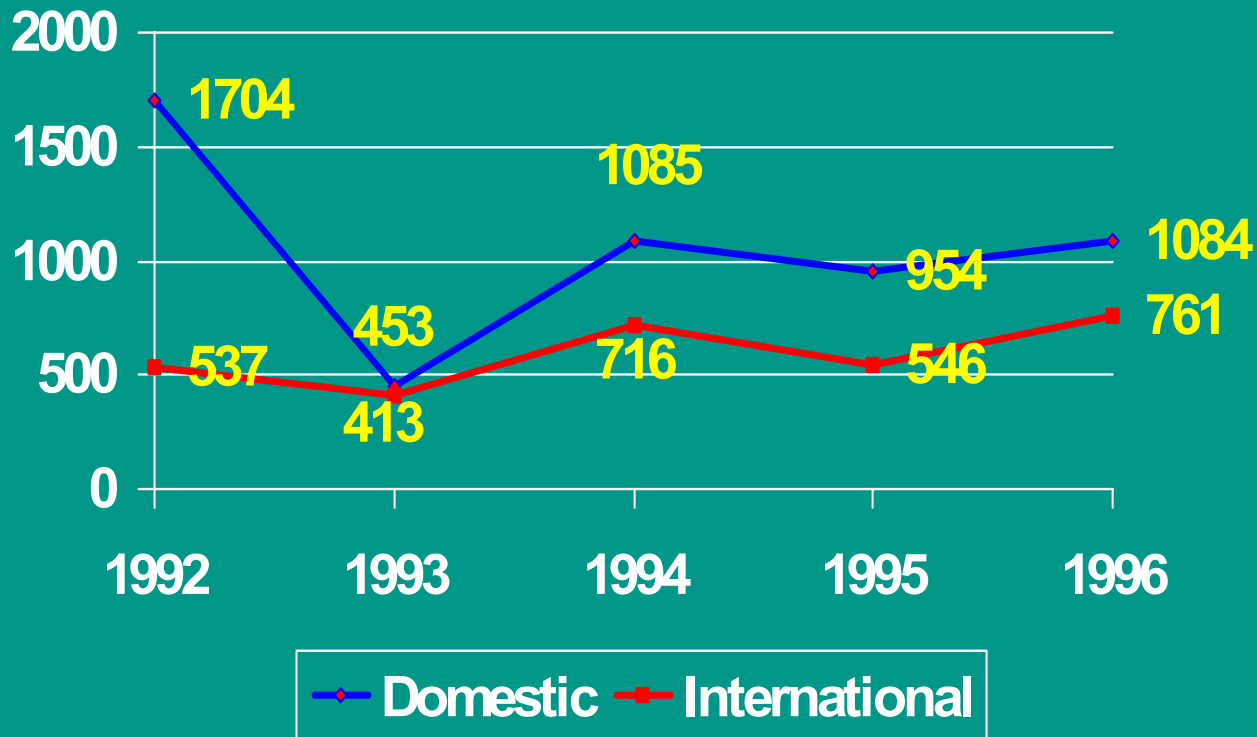
Domestic vs. International Sales - R.J. Reynolds

(Figures are in millions of dollars)



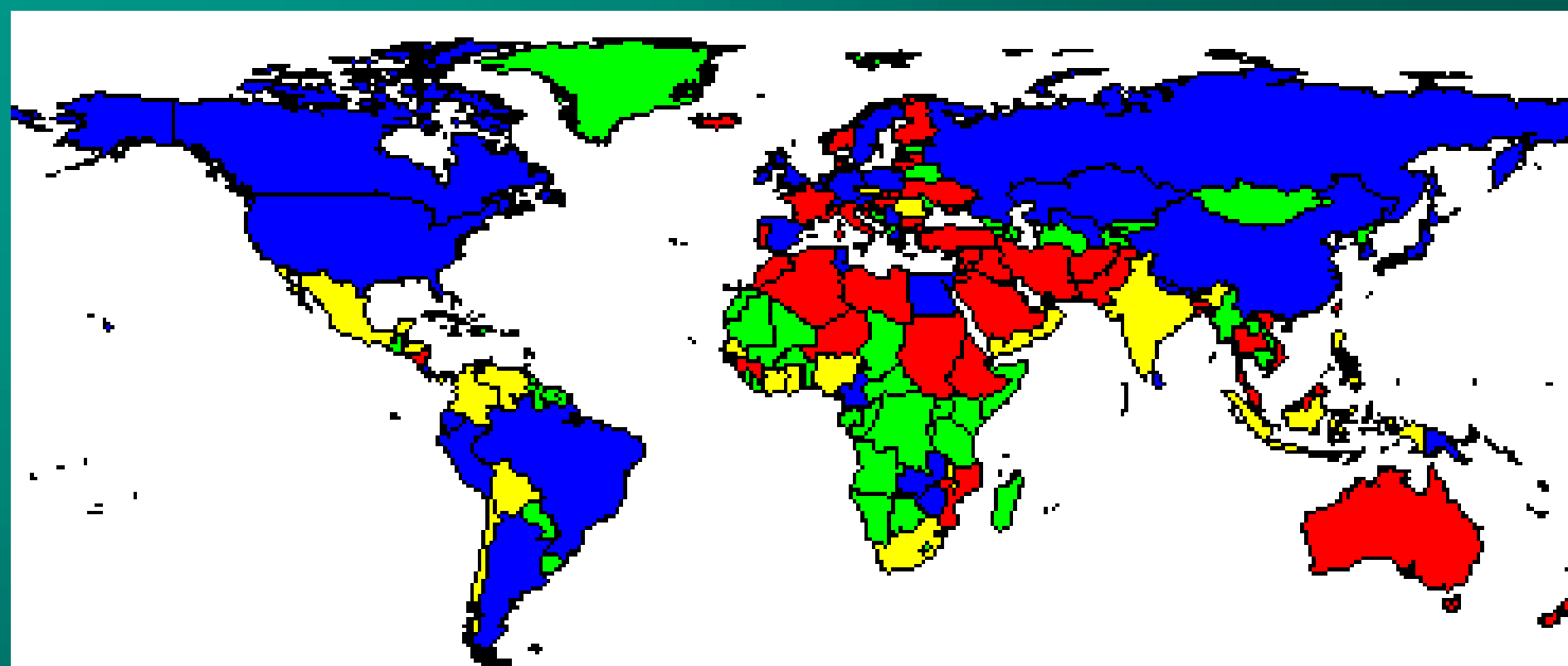
Domestic vs. International Operating Profit - R.J. Reynolds

(Figures are in millions of dollars)



Global Trends

- **Product Trends**
- **Financial Trends**
- **US Settlement & Public Policy Trends**
 - Anti-Tobacco Campaigns,
 - Marketing Restrictions,
 - Ingredient Disclosure, Taxation



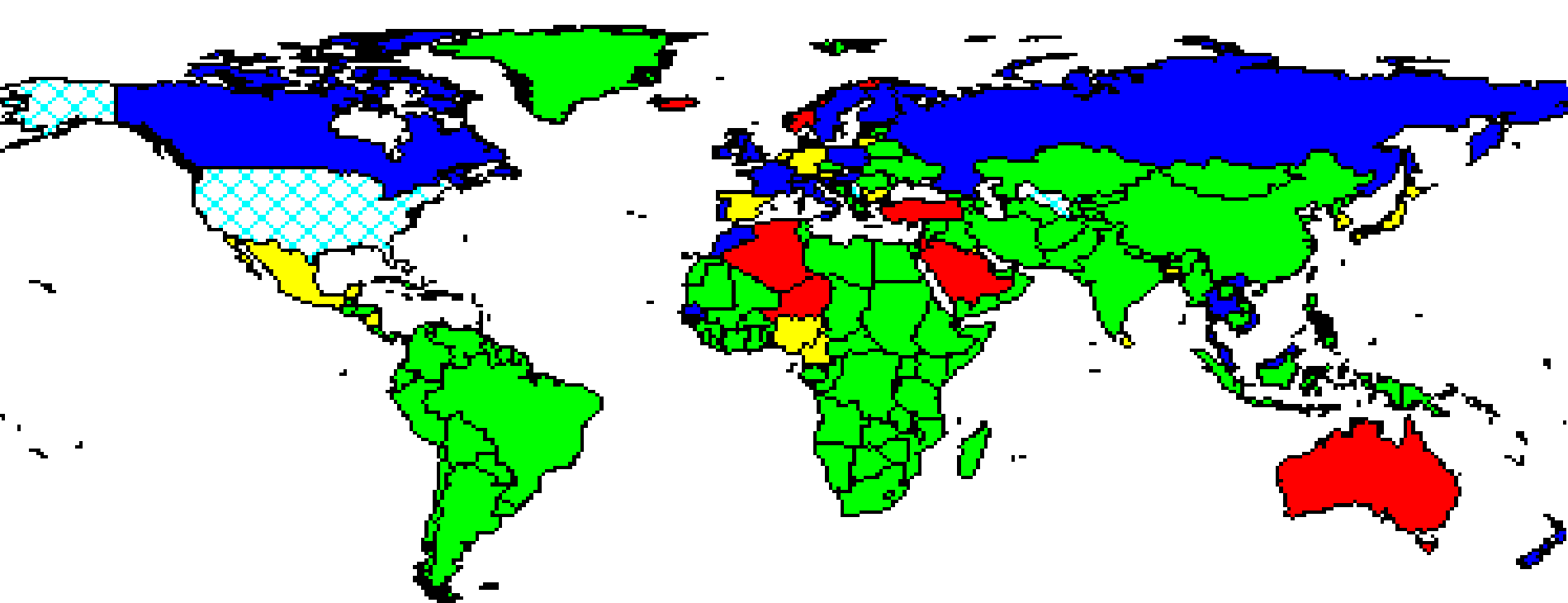
Tobacco Marketing Restrictions: 1997

Tobacco advertising and/or promotional ban.

Broadcast and print restrictions.

Broadcast restrictions.

No restrictions known.



Tobacco Promotion Policy

Tobacco promotion ban.

Collateral advertising and sponsorship restrictions.

Collateral advertising restrictions.

Sponsorship restrictions.

No restrictions known.

Constituent Limits & Disclosure (Examples)

- **European Union.** 15mg 'tar' and 1.5mg nicotine by January 1, 1993. 12mg 'tar' and 1.2mg nicotine by January 1, 1998.
- **Australia.** Voluntary limits: nicotine 1.4mg; condensate 14mg; CO 20mg.
- **GCC.** 10.0mg 'tar,' 0.6mg nicotine, 12.0mg CO.
- **Thailand.** Starting October 20, 1997, manufacturers will be required to disclose to the public ingredients contained in all tobacco products.
- **Bulgaria.** 15mg 'tar' limit, effective January 1, 1993.

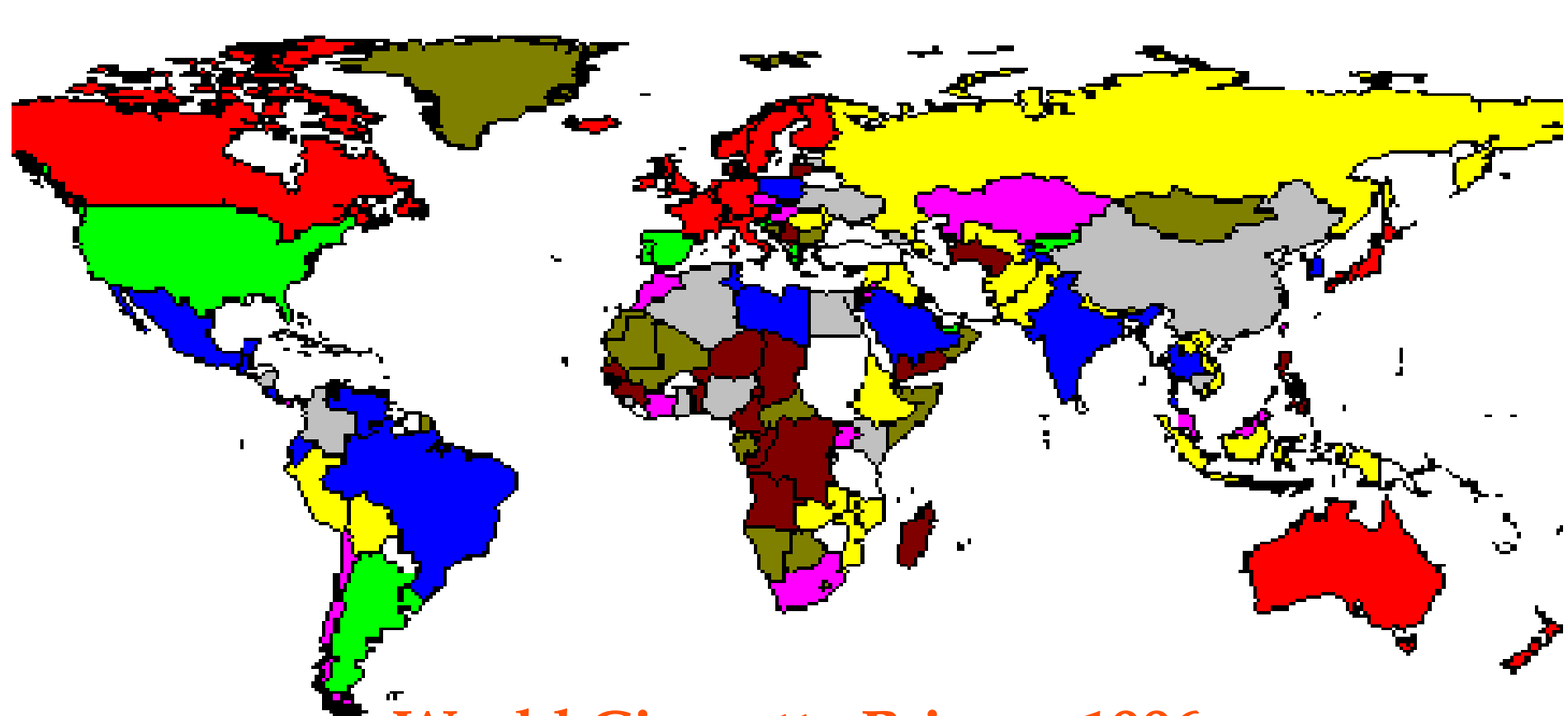
Cigarette Prices 1990 - 1996

1990

1996

US	\$1.60	US	\$1.95
Norway	\$5.00	Norway	\$6.82
Denmark	\$4.09	Denmark	\$5.07
Finland	\$3.66	Finland	\$4.58
UK	\$3.12	UK	\$4.40
Australia	\$2.06	Australia	\$4.08
France	\$1.89	France	\$3.51
Germany	\$2.74	Germany	\$3.32
Hong Kong	\$1.54	Hong Kong	\$3.23
Japan	\$1.52	Japan	\$2.02

All Prices are in US Dollars per pack of 20.



World Cigarette Prices - 1996

Over \$2.40 per pack of 20.

Between \$1.31 and \$2.40 per pack of 20.

Between \$0.92 and \$1.31 per pack of 20.

Between \$0.66 and \$0.92 per pack of 20.

Between \$0.59 and \$0.66 per pack of 20.

Between \$0.48 and \$0.59 per pack of 20.

Between \$0.38 and \$0.48
per pack of 20.

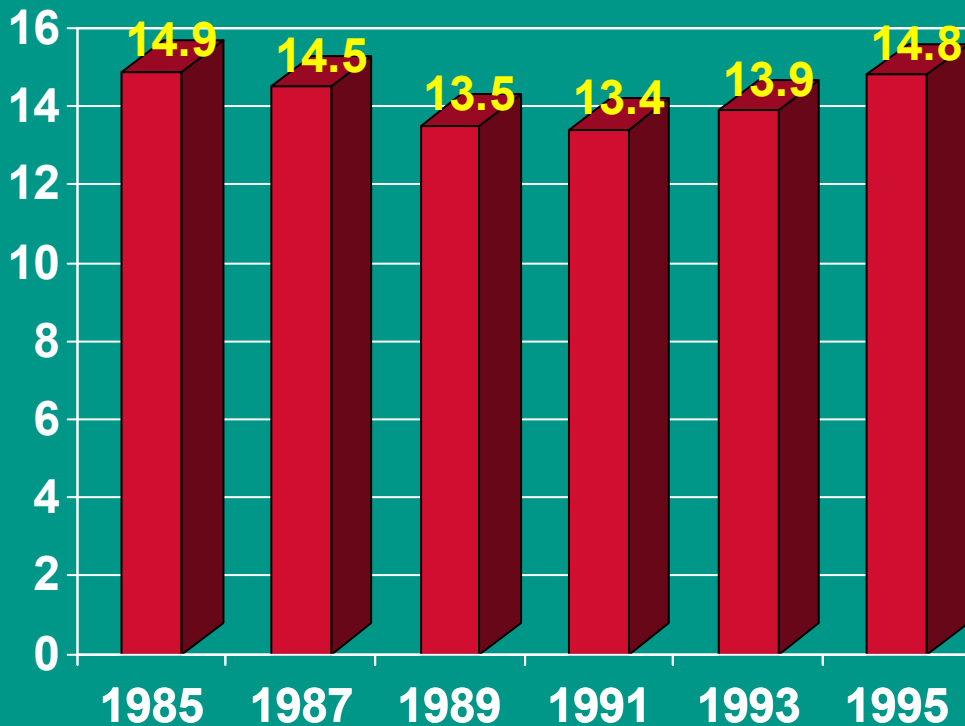
Below \$0.38 per pack of 20.

The US Settlement

- SO HOW DID IT HAPPEN THAT THE US MANUFACTURERS WENT TO A HOSTILE GOVERNMENT LOOKING FOR A LEGISLATED SOLUTION TO THE INDUSTRY'S PROBLEMS?
- AND WHAT WILL THE ECONOMIC IMPACT BE OF WHAT IS CURRENTLY ON THE TABLE?

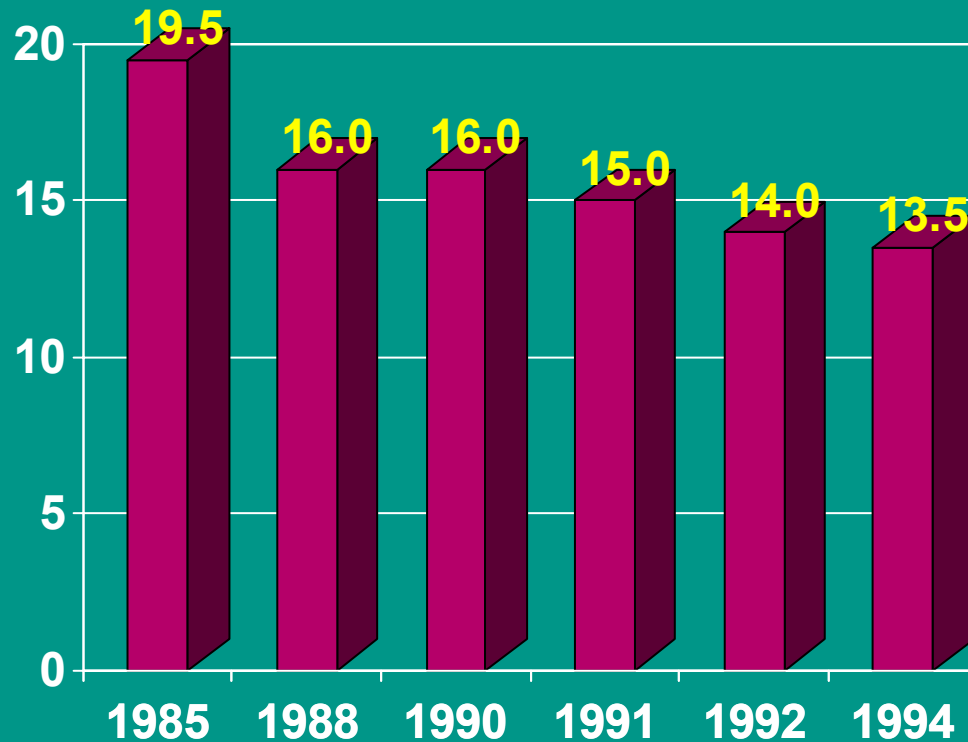
The Growing U.S. Youth Population

(Millions of People Aged 14-17)



The Declining U.S. Youth Smoking Incidence

(Percentage for those aged 14-17)



Youth Smoking Statistics in the U.S.

According to a recent Federally-funded survey:

- Smoking rates have increased for five consecutive years (1991-96) as the proportion of surveyed students using tobacco has reportedly increased by about 50% overall.
- 34% of high school seniors have smoked cigarettes.
- Between 1991-96, the percentage of 10th-graders that have smoked cigarettes rose from 21% to 30%.
- Between 1991-96, the percentage of 8th-graders that have smoked cigarettes rose from 14% to 21%.
- Between 1995-96, the percentage of 8th and 10th grade students reporting any cigarette smoking in the previous 30 days increased by about 10%.

The US Attorneys General

- **May 23, 1994** A then little known Attorney General from Mississippi, Michael Moore, files the first class action lawsuit against cigarette manufacturers for repayment of **medicaid expenses**.
- **March 8, 1995** Four states -- Florida, Mississippi, Minnesota, and West Virginia-- announce the **National Coalition of States for Tobacco Liability**

Chronology of FDA Regulations

- **August 8, 1995.** President Clinton announces his support for FDA regulation.
- **August 10, 1995.** Industry files suit seeking to block the regulations.
- **August 11, 1995.** FDA announces its proposed tobacco rules in the *Federal Register*.
- **October 4, 1995.** Tobacco companies suing the FDA file a 39-page summary judgment, asking Judge Osteen to rule on the issue.
- **December 1, 1995.** The FDA releases its findings of focus group testing on proposed warning labels to be carried in cigarette advertising.
- **January 2, 1996.** Five cigarette manufacturers jointly submit their 2,000-page comments to the FDA supported by 45,000 pages of appendices. Arguments include that the FDA exceeded its legal authority when it issued the proposed regulation.

Chronology of FDA Regulations

- **May 15, 1996. Philip Morris USA and United States Tobacco Co.** announce a blueprint for comprehensive Federal legislation to address tobacco use by minors.
- **August 23, 1996.** FDA announces in the *Federal Register* its **final rule** on tobacco.
- **December 2, 1996. FDA defends its legal authority** to regulate tobacco products in a brief filed in U.S. District Court.
- **February 10, 1997. U.S. District Judge William Osteen** holds a hearing on the FDA's tobacco regulation.
- **February 28, 1997. First phase of the FDA rule takes effect** establishing a Federal minimum sales age of 18.
- **April 25, 1997. U.S. District Judge Osteen rules** that the FDA does have regulatory authority over cigarettes and smokeless tobacco, but cannot impose marketing restrictions.

August 9, 1996

B&W Loses the Carter Case

- \$750,000 awarded to a smoker of Lucky Strike cigarettes in the failure to warn and strict liability case of Carter v. American Tobacco Co. [ATC] in a **Jacksonville, Florida court.**
- The case marked only the second time damages were awarded to a plaintiff in such cases. But the first case in New Jersey, the Cipollone case, was later reversed on appeal.
- First time **internal B&W documents** were presented to a jury in a tobacco case.
- **Case is now on appeal.**

FDA Final Rule: Sales Restrictions

August 23, 1996

- 18 minimum sales age.
- Photo ID for individuals 26 or younger.
- 20 cigarettes minimum pack size.
- Vending machines restricted to places where minors are expressly prohibited by law.
- Self-service displays banned, with certain, limited exceptions.
- Mail order sales allowed.
- Coupons allowed.
- Free samples prohibited.

FDA Final Rule: Marketing Restrictions

August 23, 1996

- Limit tobacco advertising in all existing media forms to a black-and-white, text-only format (“Tombstone”).
- Outdoor advertising is prohibited within 1,000 feet of public playgrounds, elementary schools or secondary schools.
- Advertisements in publications read primarily by adults and advertisements placed in adult-only locations are exempt from any advertising restrictions.
- Dissemination of any non-tobacco item or service that identifies it with a tobacco product is prohibited.

FDA Final Rule: Marketing Restrictions

August 23, 1996

- Contests, lotteries, or games of chance are allowed, provided ads appear in “Tombstone” format.
- Sponsorship in Corporate name only.
- Brand name sponsorship, logos, color are banned.
- Brand name sponsorship of race cars as well as other teams or entries are prohibited.
- FDA to send letters to the manufacturers explaining why the agency believes that a national, multi-media anti-tobacco campaign is needed.

The US Attorneys General

- By the end of 1996 18 had States filed Medicaid lawsuits: Arizona, Connecticut, Florida, Kansas, Illinois, Iowa, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, New Jersey, Oklahoma, Texas, Utah, Washington, & West Virginia
- Also Erie County, NY; Los Angeles County, CA; City and County of San Francisco; and New York City, NY filed local lawsuits.

Liggett Settlement

- **March 15, 1996.** Liggett Group announces settlement **with 5 suing Medicaid States.**
- **March 20, 1997.** Liggett Group **settles with 22 States seeking reimbursement to Medicaid accounts.**
- Agreement calls for \$25 million lump sum payment plus 25% of Liggett's pre-tax profits.
- Lump sum payment only to be triggered if Liggett buys, or is bought by another tobacco company.
- **March 28, 1997.** Brooke Group Ltd., parent to Liggett, announces 1996 losses at \$62.5 million.
- **March 31, 1997.** Liggett announces it cannot pay its previous debt.

Pre-Settlement Proposal: PM/UST vs. FDA Sales Restrictions

Philip Morris/UST May 15, 1996

- Legislation.
- Cigarettes and Smokeless products only.
- Sales to minors (18) prohibited.
- Vending machines effectively prohibited.
- Coupons, self-service displays, sampling **restricted** to "face-to-face."
- No less than 20 sticks per pack

FDA August 8, 1995

- Regulation.
- Cigarettes and Smokeless products only.
- Sales to minors (18) prohibited.
- Vending machines effectively prohibited.
- Coupons, self-service displays, sampling all **prohibited**.
- No less than 20 sticks per pack.

Pre-Settlement Proposal: PM/UST vs. FDA

Advertising Restrictions

Philip Morris/UST

- Ban all advertising within 1,000 feet of playgrounds or schools.
- Ban ads in retail windows within 1,000 feet of playgrounds or schools.
- Ban ads at public on or in transportation, including stops and shelters.
- Ban ads in publications in which youth account for 15% or more of the readership.

FDA

- Ban all advertising within 1,000 feet of playgrounds or schools.
- “Tombstone” only format for all other ads, including ads at retail stores.
- “Tombstone” only format on public transportation.
- “Tombstone” only format in publications in which minors comprise 15% of readership or more than 2 million readers.

Pre-Settlement Proposal: PM/UST vs. FDA Sponsorship Restrictions

Philip Morris/UST

- Brand name sponsorship **allowed**.
- Brand names allowed on entries and teams in events.
- Event promoter must certify that at least 75% of the audience is 18 years of age or older.

FDA

- Brand name sponsorship **prohibited**.
- Excludes teams or entries in events, such as stockcars, used before January 1, 1995.
- Corporate sponsorship only.

Pre-Settlement Proposal: PM/UST vs. FDA Funding

Philip Morris/UST

- \$250 million in total over a five year period.
- Proceeds used to pay for costs associated with the administration and enforcement of the sales and distribution restrictions.
- Review after 5 years. If deemed necessary, further legislation.
- Funding based on industry-wide market share.

FDA

- \$150 million annually or \$750 million over five years.
- Proceeds used for a “corrective education program” of counter-advertising.
- If in 7 years smoking by minors is not reduced to 50% of the 1993 rate, more steps would be taken.
- Funding based on dollars spent on advertising as reported to the FTC.

Liggett Settlement

March 20, 1997

- Liggett says it now believes that cigarettes are addictive and cause cancer.
- Liggett agrees to print new warnings on its packs including, "WARNING: SMOKING IS ADDICTIVE."
- Liggett agrees to give internal documents to the suing Attorneys General most significantly documents of the Committee of Counsel. Other manufacturers claim attorney client privilege and say they won't be coerced into buying Liggett.

Liggett Settlement

March 20, 1997

- Other U.S. cigarette manufacturers say terms of Liggett's deal show it to be nothing more than a **financial and legal "charade."**
- 25% of pre-tax profits into a fund. Liggett, however, is operating at a loss.
- \$25 million lump sum payment only triggered if Liggett buys, or is bought by another tobacco company.
- Liggett not in a position to buy another cigarette manufacturer, and no other cigarette manufacturer is interested in buying Liggett.

U.S. District Court Ruling

April 25, 1997

- Ruling made on April 25, 1997 by U.S. District Judge William L. Osteen in Greensboro, North Carolina.
- Judge Osteen rules that the FDA does have regulatory authority over cigarettes and smokeless tobacco products, but cannot impose advertising and promotional restrictions.
- Manufacturers, ad agencies and others file appeal on April 30, 1997 in the U.S. 4th Circuit Court of Appeals in Richmond, Virginia. Clinton Administration files appeal shortly thereafter.
- August 11, 1997, three judge appellate court hears appeals. No date set for ruling.

U.S. District Court Ruling

April 25, 1997

- Marks the first time a court has upheld FDA authority to regulate **access** to tobacco products.
- Allows FDA regulations implemented February 28, 1997 prohibiting the sale of tobacco products to minors to remain in full force and effect pending appeal by Plaintiffs.
- FDA rule presently effects retailers.
- Retailers are to: not sell cigarettes or smokeless tobacco products to anyone under 18; verify that anyone buying such products is at least 18 years of age or older; check photo identification of anyone under 27 years of age.

U.S. District Court Ruling

April 25, 1997

- The FDA may regulate tobacco products pursuant to the *Federal Food, Drug, and Cosmetic Act*.
- Tobacco products fall within the “drug” and “device” definitions of the *Act*.
- Tobacco products’ effects are “intended” within the meaning of the *Act*.
- Tobacco products affect the structure or function of the body within the meaning of the *Act*.
- FDA may regulate tobacco products as medical devices pursuant to its device authorities.
- Tobacco products are combination products within the meaning of the *Act*.

U.S. District Court Ruling

April 25, 1997

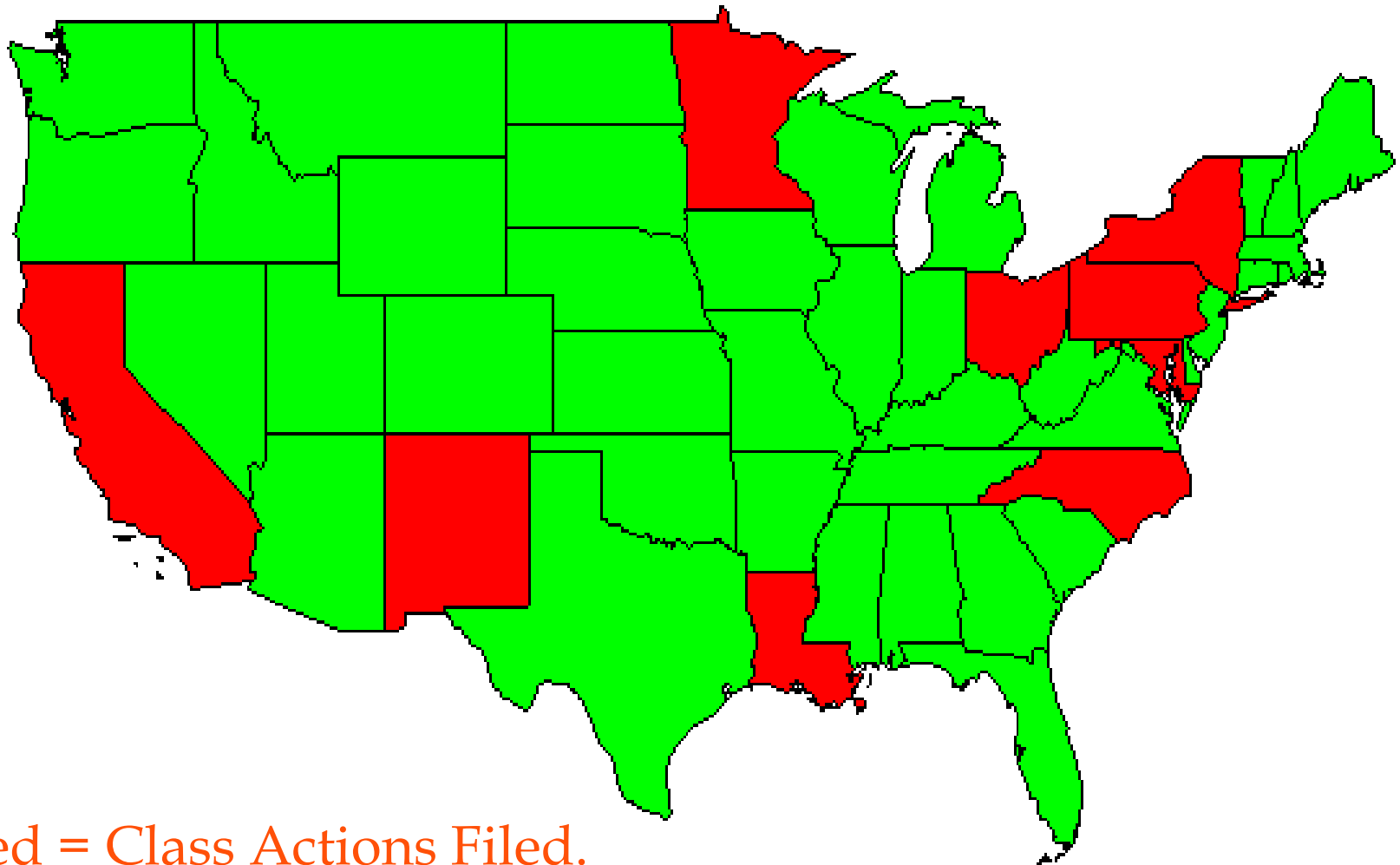
- Portions of the FDA's Regulations are not authorized under the *Federal Food, Drug, and Cosmetic Act*.
- Section 360j(e) does not authorize restrictions on the promotion and advertisement of tobacco products.
- Section 360j(e) authorizes the FDA to impose restrictions on access to tobacco products.
- Section 352 authorizes the FDA to impose labeling restrictions on tobacco products.
- **But if the FDA has jurisdiction over tobacco, how can they do anything but ban it?**

Chronology of FDA Regulations

- April 30, 1997. The four major U.S. cigarette manufacturers file an appeal with the Fourth U.S. Circuit Court of Appeals in Richmond, Virginia.
- Manufacturers appeal parts of Osteen's ruling dealing with FDA regulatory authority.
- May 2, 1997. The U.S. Justice Department files an appeal with the Fourth U.S. Circuit Court of Appeals in Richmond, Virginia.
- Justice appeals parts of Judge Osteen's ruling that the FDA cannot regulate cigarette advertising and promotion.

Class Action Lawsuits

(As of May 20, 1997)



Red = Class Actions Filed.

US Settlement

■ INGREDIENT DISCLOSURE

Massachusetts: 1996

Minnesota: 1997

Texas: 1997

More reasons for a US Settlement

The US Attorneys General

- By June 1997 37 US States had formally sued cigarette manufacturers with tobacco producing states noticeably absent.
- Simultaneously RJR was defending Joe Camel, under attack in California
- The US Justice Department deepened its then 2-year investigation into fraud and perjury in testimony before Congress in 1994
- Concerns about Y-1 nicotine-manipulated tobacco were still present

TOBACCO LITIGATION

■ Private Sector

1. Product Liability (Punitive Damages)
 - a. Individual Cases
 - b. Class Action Cases
2. Worker ETS Exposure / Disability
3. Public Place ETS Exposure

■ Government Sector

1. Nicotine as a “Drug”
2. Product Standards (“Tar,” Nic, CO)
Additives, Humectants, Flavorings, Pesticides
3. Anti-Trust / Marketing / Smuggling
4. Smoking Restrictions

Tobacco Settlement Announced

June 20, 1997

- All class action and medicaid suits settled
- Annual Payments: \$8.5 billion initially rising to \$15 billion annually thereafter indexed at 3% or CPI
- Allows FDA to ban nicotine in 2009 but only if FDA can prove a black market won't be created. Allows creation of a board to oversee product standards
- \$2 billion annual cap if youth smoking does not decline 30% in 5 years, 50% in 7 years, and 60% in 10 years -- the so-called "Look Back" provisions
- Tombstone print ads except in adult publications; point-of-sale only in adult establishments. Other marketing activities banned.

Tobacco Settlement Announced

June 20, 1997

- New stronger health warnings on packs to cover 25% of front panels except hinge-lid hard packs
- Bans all vending machines, self-service displays, mail-order sales; set 18 as minimum age and photo identifications for under 27
- Creates nationwide smoking restrictions for public and work places obviating the need for OSHA's rule; exempts restaurants, bars, private clubs, hotel rooms, casinos, prisons, tobacco stores
- Tobacco Institute and CTR dissolved though they can be reformed with outside directors
- \$17.2 billion for tobacco farmers

Tobacco Settlement

Issues Surface

- Greater nicotine regulatory powers for FDA
- \$2 billion penalty cap on “Look Back” provisions should be raised.
- Congressional approval allowing the application of a credit for the new cigarette and smokeless taxes -- worth an estimated \$50 billion over 25-years -- against the settlement should be eliminated.
- Higher escrow payments by importers calculated at 150% of their liability should be reduced to 100% the same as the settlement signatories.
- **Radical Anti-Tobacco Wing:** It requires smokers and chewers to continue smoking and chewing.

Tobacco Settlement Issues Surface

- Bennett Lebow, chief executive officer of Brooke Group, Liggett's parent, says that the settlement will bankrupt Liggett...though Dukat is split financially from Liggett, just in case.
- Argues that Liggett should get special treatment as the "whistle blower".

Congressional Hearings

- **December 10, 1997.** House Committee on the Judiciary Subcommittee on Courts hears testimony from Florida Governor Chiles, and others, **that States should be allowed to keep any and all settlement funds.**
- **December 9, 1997.** House Committee on Commerce Subcommittee on Health and Environment listens to the Royal Canadian Mounted Police about **Canada's experience with black market cigarettes** following rapid price increases.
- **December 8, 1997.** Administration officials tell the House Committee on Commerce Subcommittee on Health and Environment **law requires the Federal government to recover a portion of money** reimbursed to Medicaid that may be part of a State tobacco settlement.

Congressional Hearings

- **December 5, 1997.** Industry turns over 834 documents to House Commerce Chair Rep. Bliley after a December 4 subpoena. Papers posted **on the Internet** on December 18.
- **November 13, 1997.** At the first House hearing, Committee on Commerce Chairman Bliley (R-VA) vows to subpoena 834 industry documents contested in Minnesota Medicaid suit.
- **October 29, 1997.** Senate Judiciary Subcommittee discusses **anti-trust** provisions of June 20th agreement.

Congressional Hearings

- **October 27, 1997.** Senate Labor and Human Subcommittee takes testimony on “best” ways to reduce smoking among youth.
- **October 9, 1997.** Senate Commerce Committee holds third settlement hearings, this time exploring the potential public health benefits of legislation.
- **October 8, 1997.** Senate Committee on Indian Affairs hears from Native Americans on possible exclusion from Settlement provision.
- **September 30, 1997.** Senate Labor & Human Resources Committee discusses FDA jurisdiction.

Congressional Hearings

- **September 25, 1997.** Secretary of HHS Donna Shalala gives Administration's view of Settlement legislation but refuses to write specific legislation for Congress.
- **September 18, 1997.** Senate Agriculture Committee holds second hearing discussing tobacco farmers, specifically, assisting farmers and their communities.
- **September 16, 1997.** Senate Commerce Committee discusses advertising and minors issue.
- **September 11, 1997.** Senate Agriculture Chairman Lugar presents plan for an \$8 per pound quota buy-out at first Ag hearing

Congressional Hearings

- **September 3, 1997.** Senate Labor Committee testimony reveals that Settlement legislation will be pushed into 1998.
- **July 30, 1997.** Senate Judiciary Committee holds third hearing on Settlement, primarily hearing witnesses call for “full disclosure,” FDA authority, and no immunity.
- **July 29, 1997.** Dr. Koop and former FDA Head Kessler tell the Senate Commerce Committee to reject the June 20 agreement.
- **July 16, 1997.** Judiciary Committee focuses on legal issues after June 26 testimony.

McCain Settlement Legislation

- Senator McCain (R-AZ) introduces S.1414 on November 8, 1997.
- Similar to June 20th Agreement.
- Includes Senator Ford's \$28.5 billion grower provisions.
- **Upfront Payment:** \$10 billion
- **25-Year cost:** \$397 billion.
- **Annual Payment Range:** \$10.6 - \$17.1 billion.
- **Tax Deductibility:** all payments are deductible as normal business expense.
- **Youth Penalty:** \$ 80 million for each p.p. short of target.

McCain Settlement Legislation

- **FDA Jurisdiction:** FDA full jurisdiction but can not eliminate nicotine for 12 years.
- **Annual Penalty Cap:** \$2 billion.
- **Advertising:** No advertising except black & white tombstone ads in adult magazines. Limited POS advertising allowed.
- Senator McCain's bill simply **codifies the June 20th agreement** and adds financial protection for farmers.

Hatch Settlement Legislation

- Senator Hatch (R-UT) introduces S.1530 on November 13, 1997.
- **Upfront Payment:** \$10 billion.
- **25-Year Cost:** \$398.3 billion.
- **Annual Payment Range:** \$9.8 - \$16.5 billion.
- **Tax Deductibility:** all payments are deductible as normal business expense.
- **Youth Penalties:** \$100 million for each p.p. ≤ 5 . Increases to \$500 million for each p.p. after year 10.
- **Annual Penalty Cap:** \$5 billion cap $<$ yr 10; \$10 billion cap $>$ yr 10.

Hatch Settlement Legislation

- **FDA Jurisdiction:** FDA has jurisdiction to regulate tobacco as a drug. Can regulate nicotine immediately.
- **Advertising:** No advertising, except for black and white tobstone ads in adult magazines. Limited POS advertising.
- **Farmers:** \$16 billion over 25 years.
- Dramatically **increases the Look Back penalties** from original settlement and increases annual payments modestly.

Kennedy Settlement Legislation

- Senator Kennedy introduces S.1491 and S.1492 on November 8, 1997.
- S.1491 raises cigarette excise tax to \$1.89 per pack in 2002, while S.1492 provides for punitive damages.
- **Upfront Payment:** None.
- **25-Year Cost:** \$500+ billion.
- **Annual Payment Range:** N/A.
- **Tax Deductibility:** No payments are tax deductible.
- **Youth Penalties:** Significantly higher than June 20th agreement ranging from \$0.02 per pack for each p.p. ≤ 5 to \$0.06 per pack. If targets not met in 4 years, generic packaging only.

Kennedy Settlement Legislation

- **Annual Penalty Cap:** None.
- **FDA Jurisdiction:** FDA has full jurisdiction to regulate tobacco products as drug delivery device and all advertising. Can regulate nicotine immediately.
- **Advertising:** No specific restrictions described, but FDA has full authority to regulate advertising.
- **Farmers:** \$9.2 billion for growers over 3 years for tobacco communities.
- Kennedy rejects June 20th agreement except for two proposals and funds anti-smoking programs. His also includes \$1.50 per pack tax increase.

Legal Issues: McCain & Hatch

- Both **McCain** and **Hatch** legislation:
- No punitive damage claims.
- No class action claims.
- No consolidated individual claims.
- State/Local claims outlawed.

Legal Issues: Kennedy

- Allows all forms of claim against the industry including punitive damages, class action and consolidated individual cases.

Tobacco Settlement: Next Steps

- MISSISSIPPI: Medicaid lawsuit settled July 3, 1997 for \$3 billion over 25 years
- FLORIDA: Broin ETS case (class action) settled October 10, 1997 for \$300 million
- FLORIDA: Medicaid lawsuit settled August 24 for \$11.3 billion over 25 years
- FLORIDA: Wilner & Engle suits now on hold
- TEXAS: Medicaid lawsuit settled January 15, 1998 for \$15.2 billion.
- Minnesota: Medicaid Suit Next

Tobacco Settlement: Next Steps

- Settling lawsuits with the States applies pressure on Congress to act
- The Minnesota Case is unique since Blue Cross / Blue Shield is a plaintiff. Can the industry settle with a private insurer?
- Other **class actions for private insurers** are now moving: Washington State vs. Pennsylvania.
- **Asbestos Cross-Actions** Now Appear
- And the Appellate Court Decision on FDA Authority has still not been rendered

Tobacco Settlement: Next Steps

- And the **Appellate Court Decision** on FDA Authority has still not been rendered many months after the August 1997 hearing. What really is its significance at this point?
- **Has the Settlement Become a Political Football?** Trent Lott & Newt Gingrich for the Republicans vs. Bill Clinton & Ted Kennedy for the Democrats
- **March 16, 1997** Deadline set by Sen. Conrad (D-ND) for committee proposals
- Hatch-Bliley (R) vs. Conrad-Fazio (D)

The US Settlement

- SO LET'S TAKE A LOOK AT WHAT THE LIKELY ECONOMIC IMPACT MIGHT BE OF THE NEW PRICE LEVELS
- AND LET'S RECOGNIZE THAT PRICING CONSISTS OF THREE KEY UNDEFINED VARIABLES:
 - COSTS OF THE SETTLEMENT
 - HIGHER STATE EXCISE TAXES
 - HIGHER FEDERAL EXCISE TAXES

Tobacco Settlement: Economic Impact

- \$368.5 billion - \$750 billion
- \$550 billion average over 25 years or \$22 billion per year equates to about 4 times the current excise tax of 24 cents per pack = 96 cent price increase.
- Federal excise tax hike of 17 cents per pack plus another 10 cents in 2000 and 5 cents in 2002 for a total of a 32 cent increase or 56 cents per pack overall.
- Total Cost: $96 + 56 = \$1.52$ per pack

Tobacco Settlement: Economic Impact

- President Clinton stated that cigarette prices need to increase by "up to \$1.50 over the next decade."
- The current proposed settlement would achieve this in 5 years.
- The average retail prices on cigarettes would go up from the 1996 average price of \$1.85 by 81%, or \$1.52, to \$3.37 per pack in 2002.

Tobacco Settlement: Economic Impact

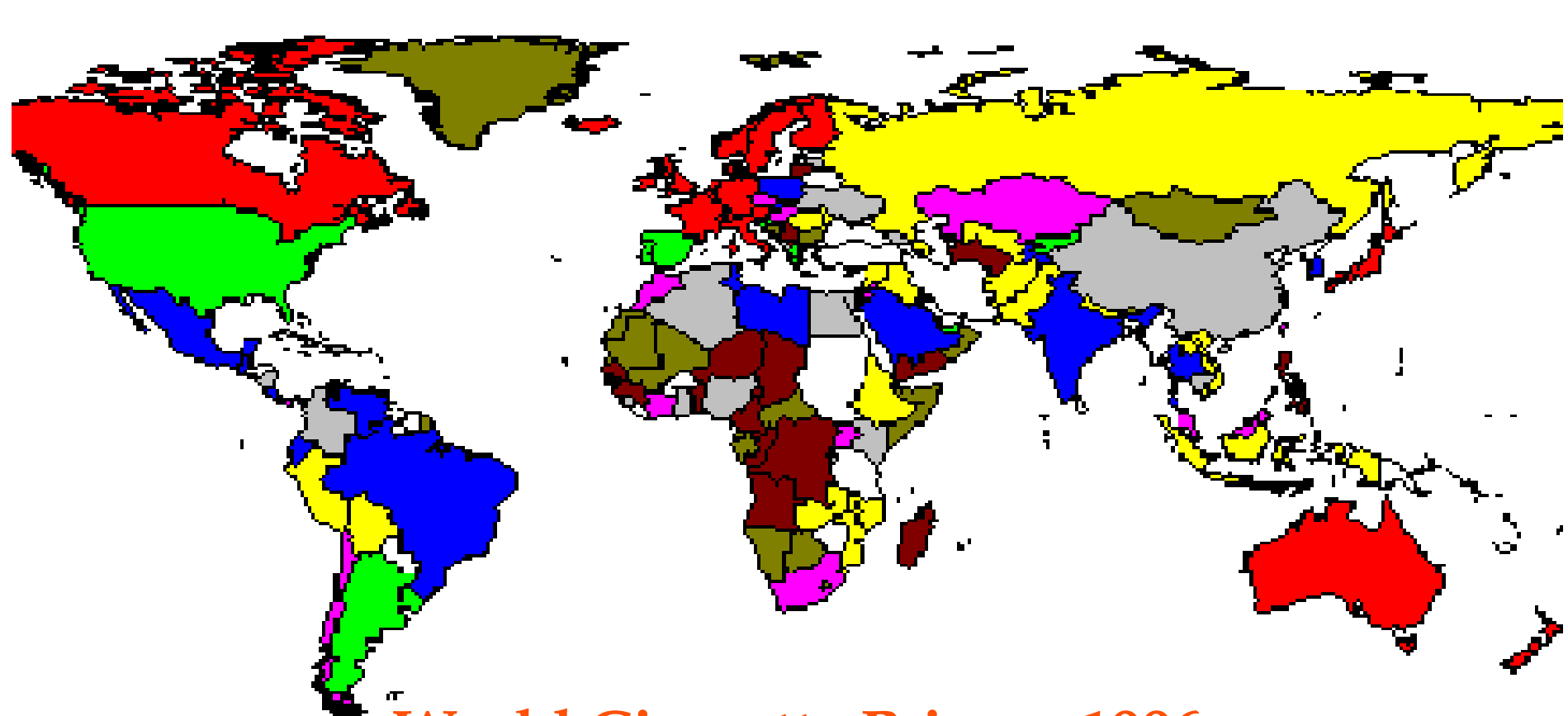
- But what about the States? Only 14 States have excise tax rates above 50 cents per pack. The other 36 could double their rates and be under Alaska's \$1.00 rate. Such a doubling would yield another roughly 40 cents per pack overall.
- Total cost = \$1.92 per pack
- Savings: litigation \$1 billion per year; marketing expenses \$5 billion per year = 40 cents per pack; **total net hike not far from the \$1.50 Mr. Clinton wants**

Tobacco Settlement: Economic Impact

- Using an elasticity of 0.4, overall U.S. volumes reportedly may fall by 21% from 484bn units in 1996 to 382bn cigarettes in 2002.
- The 7.6% price hike (7 cents per pack) September 1997, largest ever, to raise settlement funds for Mississippi, Florida, and Texas was reportedly easily absorbed by consumers.

Tobacco Trial Calendar - 1997

January 24	FLORIDA: Medicaid punitive damages hearing.
July 3	MISSISSIPPI: Medicaid lawsuit settled July 3, 1997 for \$3 billion over 25 years
June 2	FLORIDA: Broin ETS case (class action) settled October 10, 1997 for \$300 million
August 4	FLORIDA: Medicaid lawsuit settled August 24 for \$11.3 billion over 25 years
August 4	FLORIDA: Wilner lawsuit now on hold
September 8	FLORIDA: Engle lawsuit now on hold
September 22	TEXAS: Medicaid lawsuit settled January 15 for \$15.2 billion.



World Cigarette Prices - 1996

Over \$2.40 per pack of 20.

Between \$1.31 and \$2.40 per pack of 20.

Between \$0.92 and \$1.31 per pack of 20.

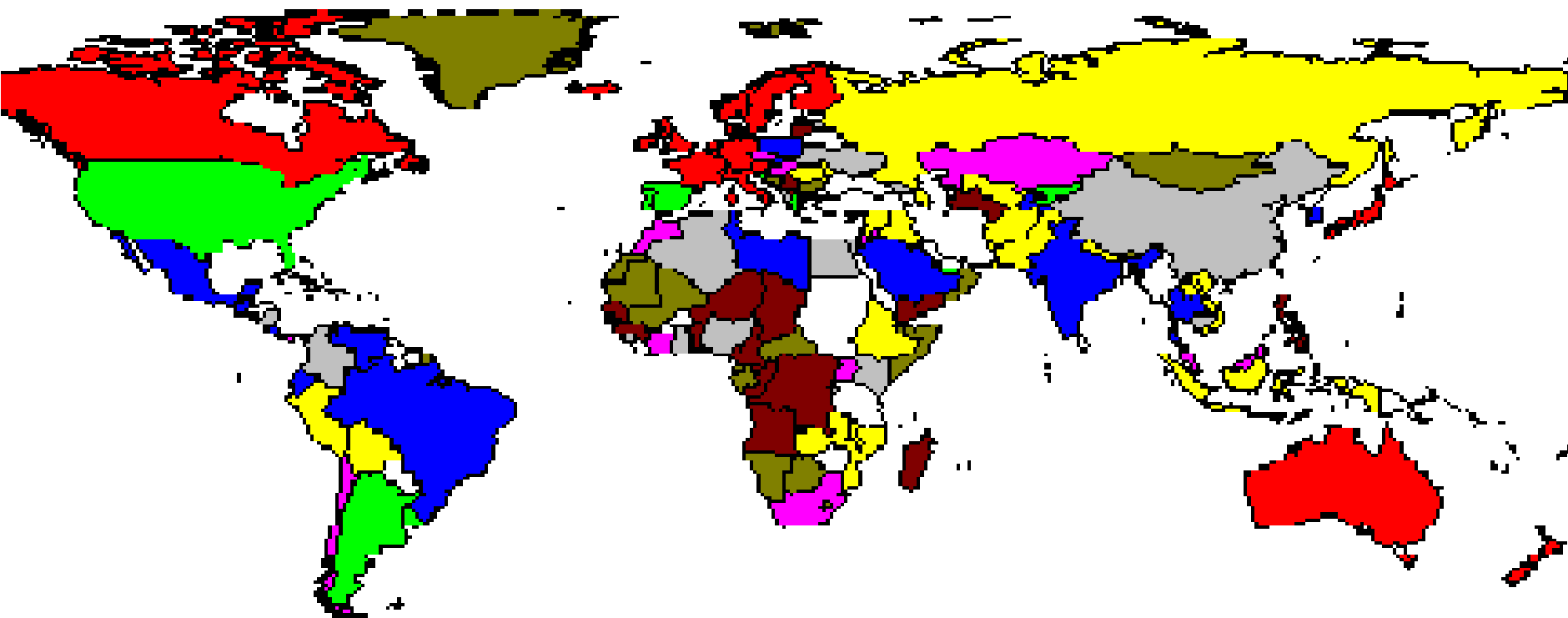
Between \$0.66 and \$0.92 per pack of 20.

Between \$0.59 and \$0.66 per pack of 20.

Between \$0.48 and \$0.59 per pack of 20.

Between \$0.38 and \$0.48
per pack of 20.

Below \$0.38 per pack of 20.



World Cigarette Prices After the U.S. Settlement

Over \$2.65 per pack of 20.

Between \$1.31 and \$2.40 per pack of 20.

Between \$0.92 and \$1.31 per pack of 20.

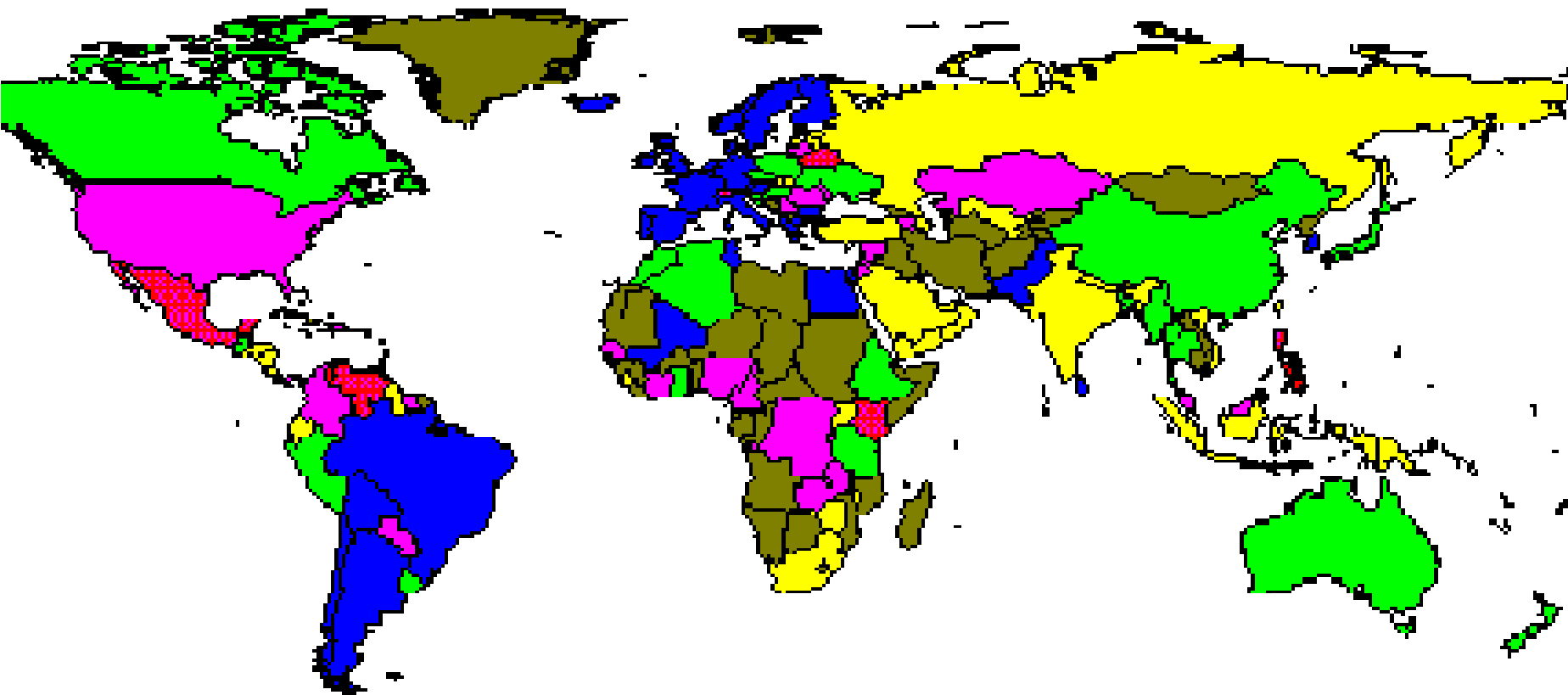
Between \$0.66 and \$0.92 per pack of 20.

Between \$0.59 and \$0.66 per pack of 20.

Between \$0.48 and \$0.59 per pack of 20.

Between \$0.38 and \$0.48
per pack of 20.

Below \$0.38 per pack of 20.



World Tax Incidence - 1996

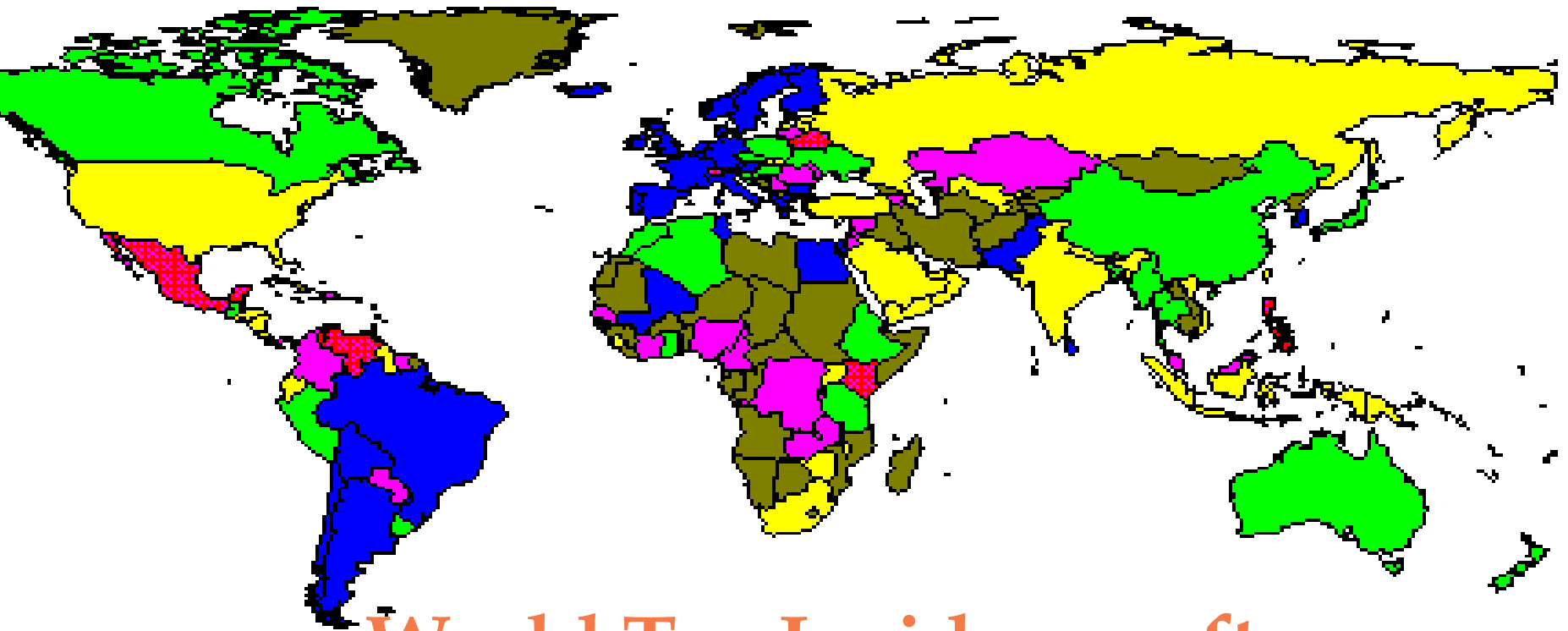
Over 68.15%

Between 55.6-68.2%

Between 52.5-55.6%

Between 38.1-52.5%

Below 38.1%



World Tax Incidence after the U.S. Settlement

Over 68.15%

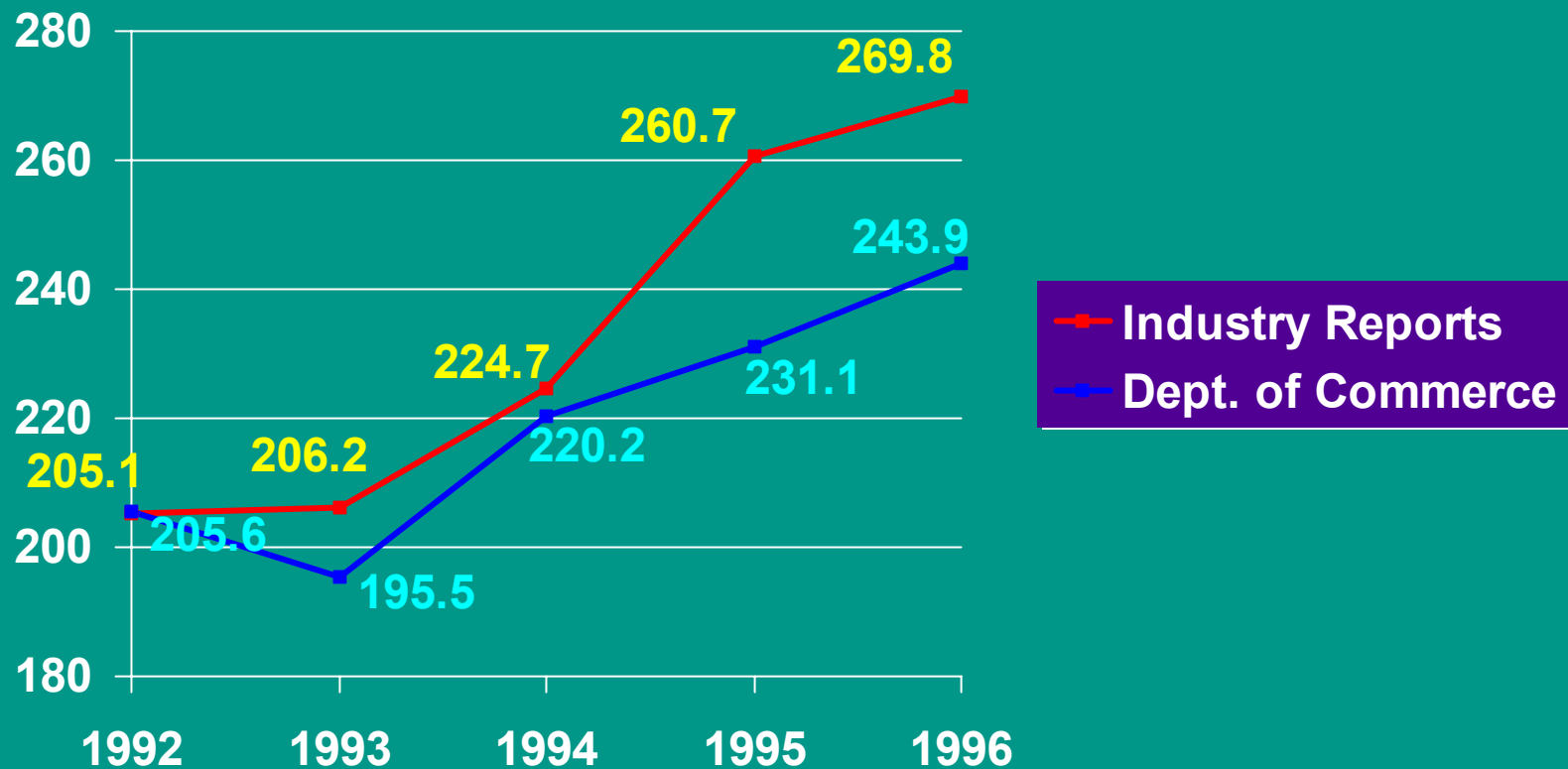
Between 55.6-68.2%

Between 52.5-55.6%

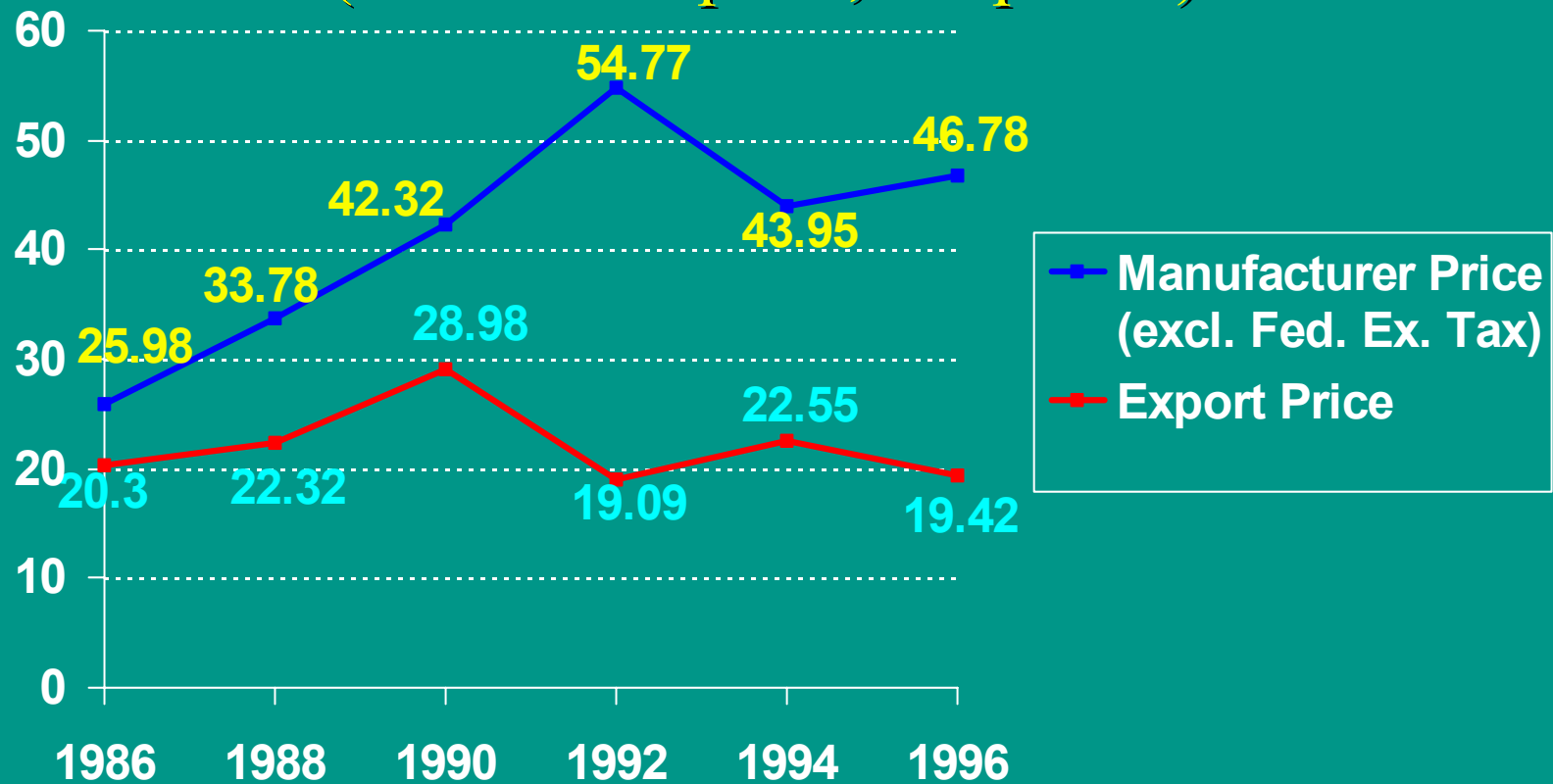
Between 38.1-52.5%

Below 38.1%

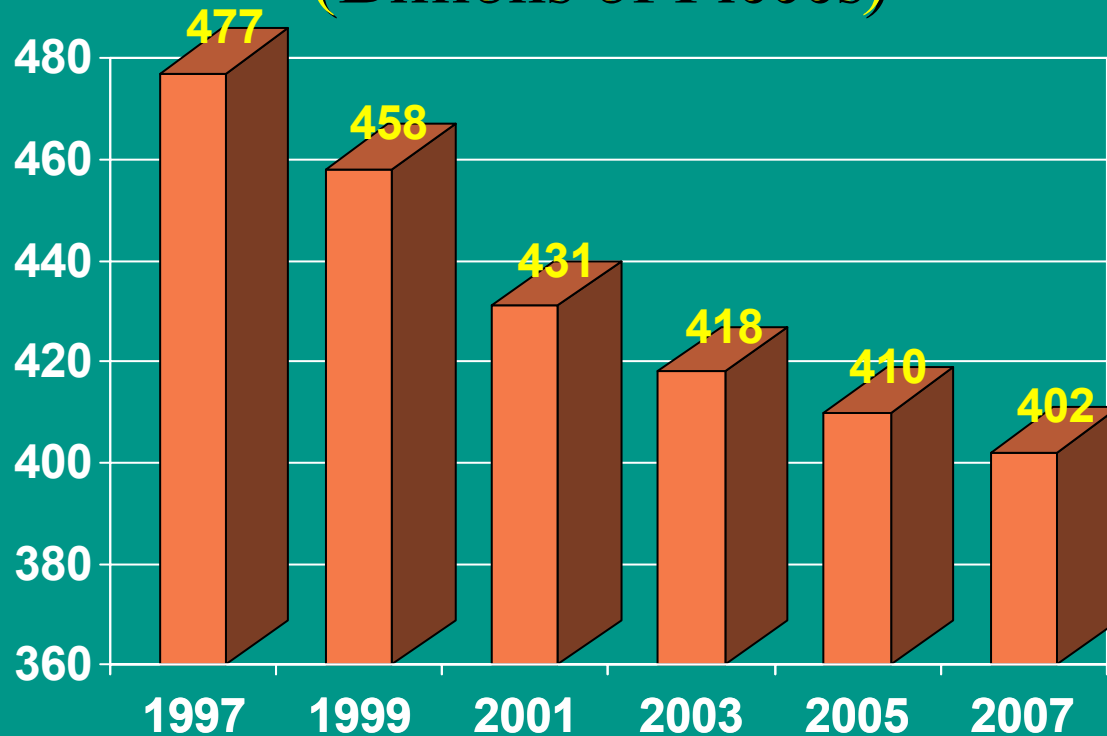
U.S. Cigarette Exports: Dept. of Commerce vs. Industry Reports (Billions of Pieces)



U.S. Cigarette Price: Manufacturer vs. Export (US Dollars per 1,000 pieces)

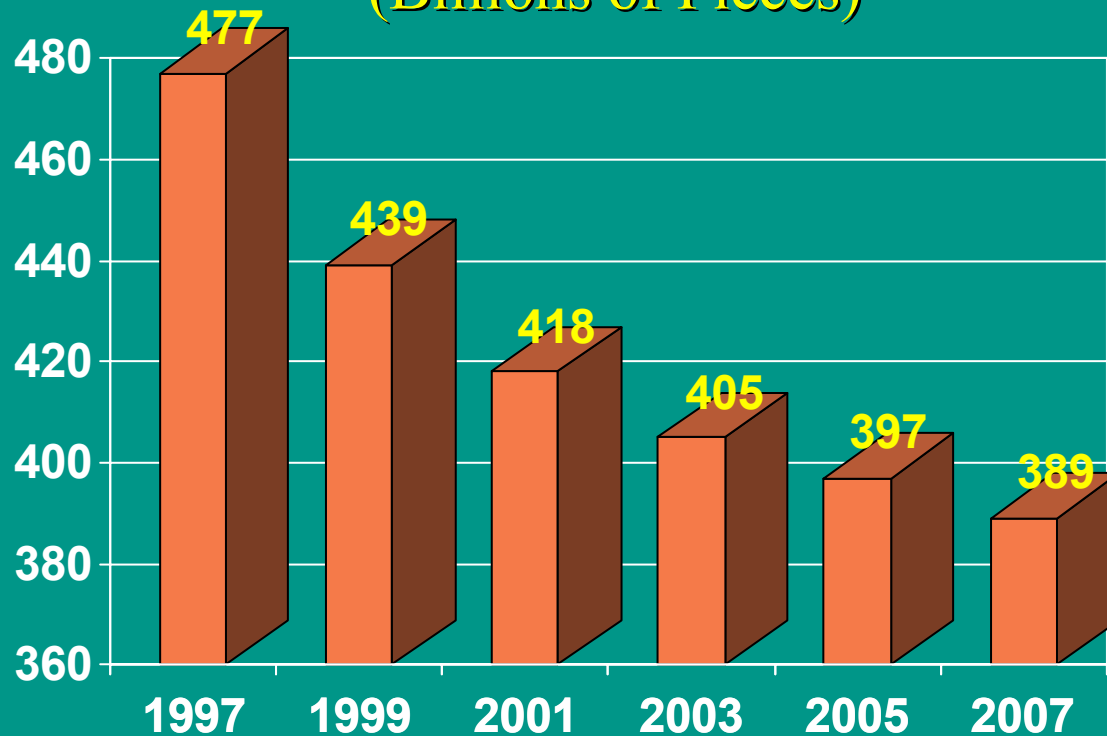


U.S. Cigarette Consumption Forecasts (Billions of Pieces)



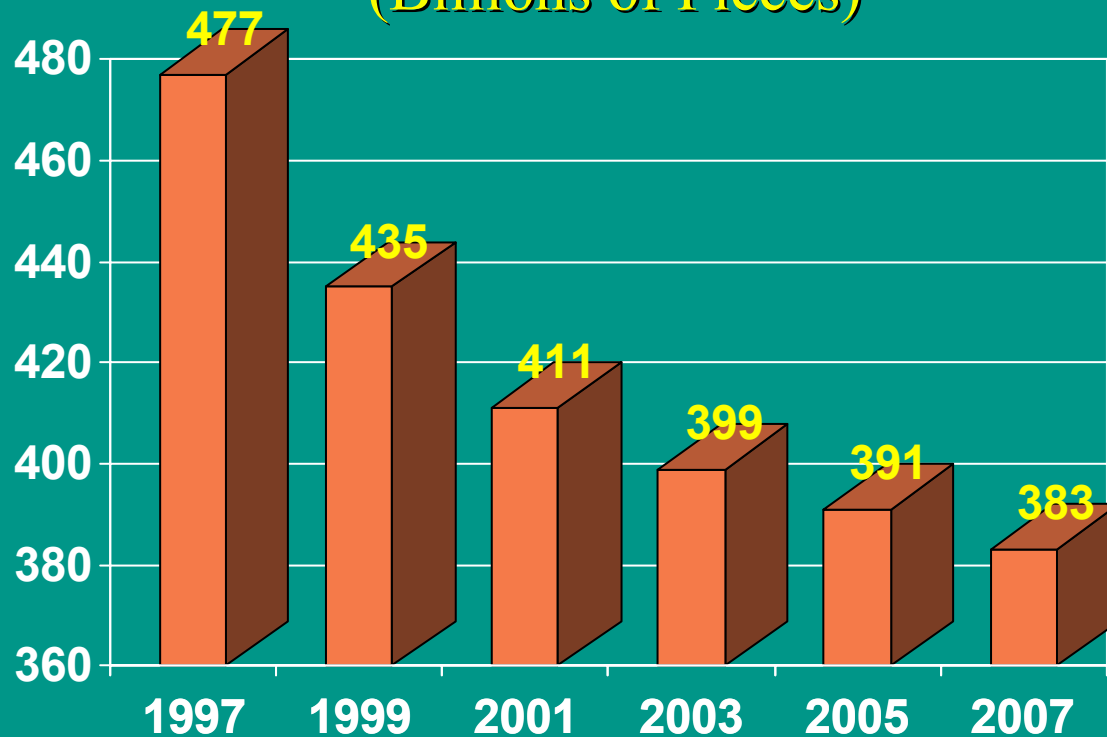
This forecast does not assume any FDA regulations or a tobacco settlement.

U.S. Cigarette Consumption Forecasts Assuming a 17 Cent Per Pack Increase in the Federal Excise Tax Takes Place in 1999 (Billions of Pieces)



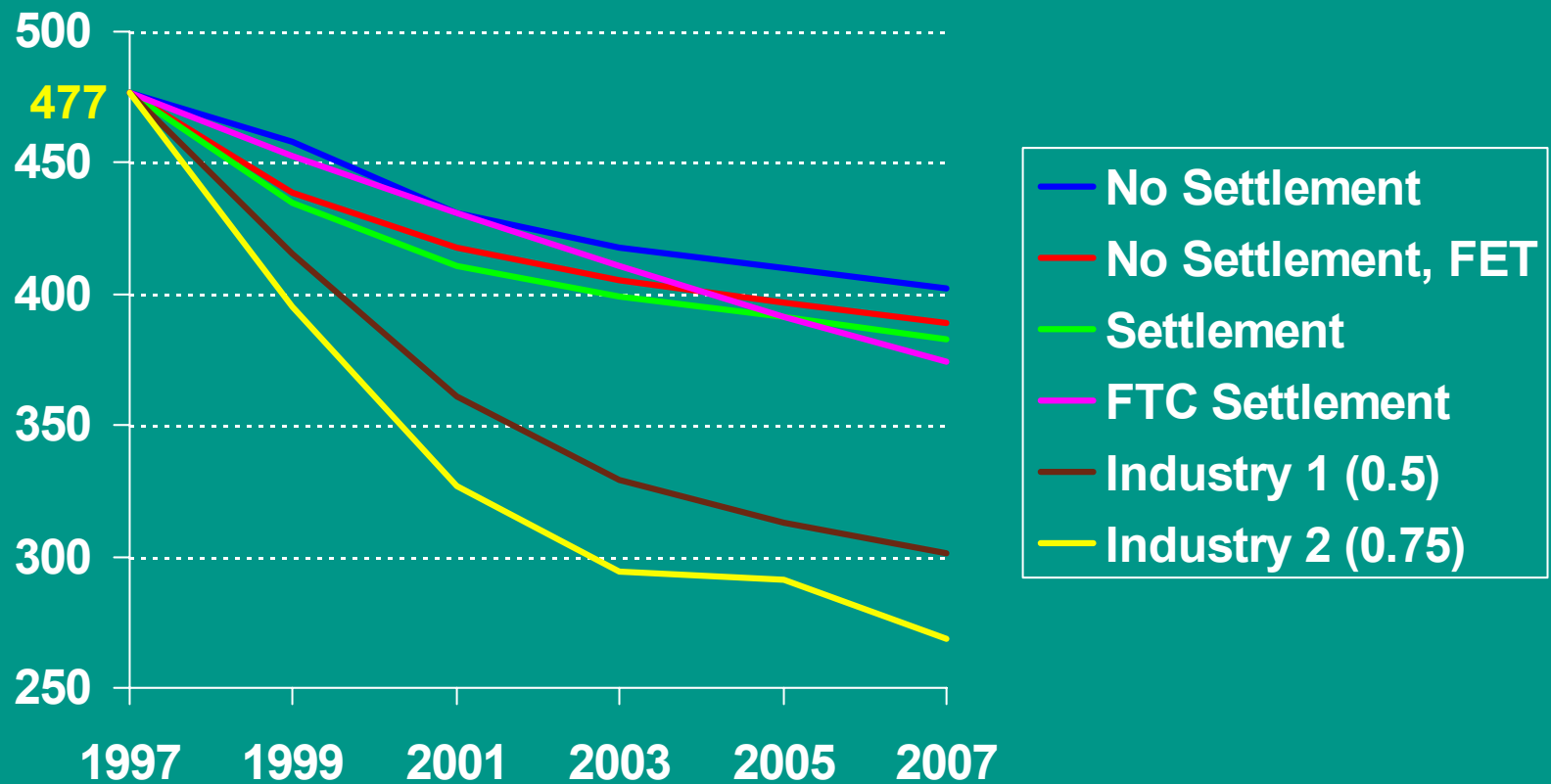
Note: Once again, these estimates assume no settlement..

U.S. Cigarette Consumption Forecasts Assuming a 40 Cent Per Pack Increase in the Manufactured Price Takes Place in 1998 (Billions of Pieces)

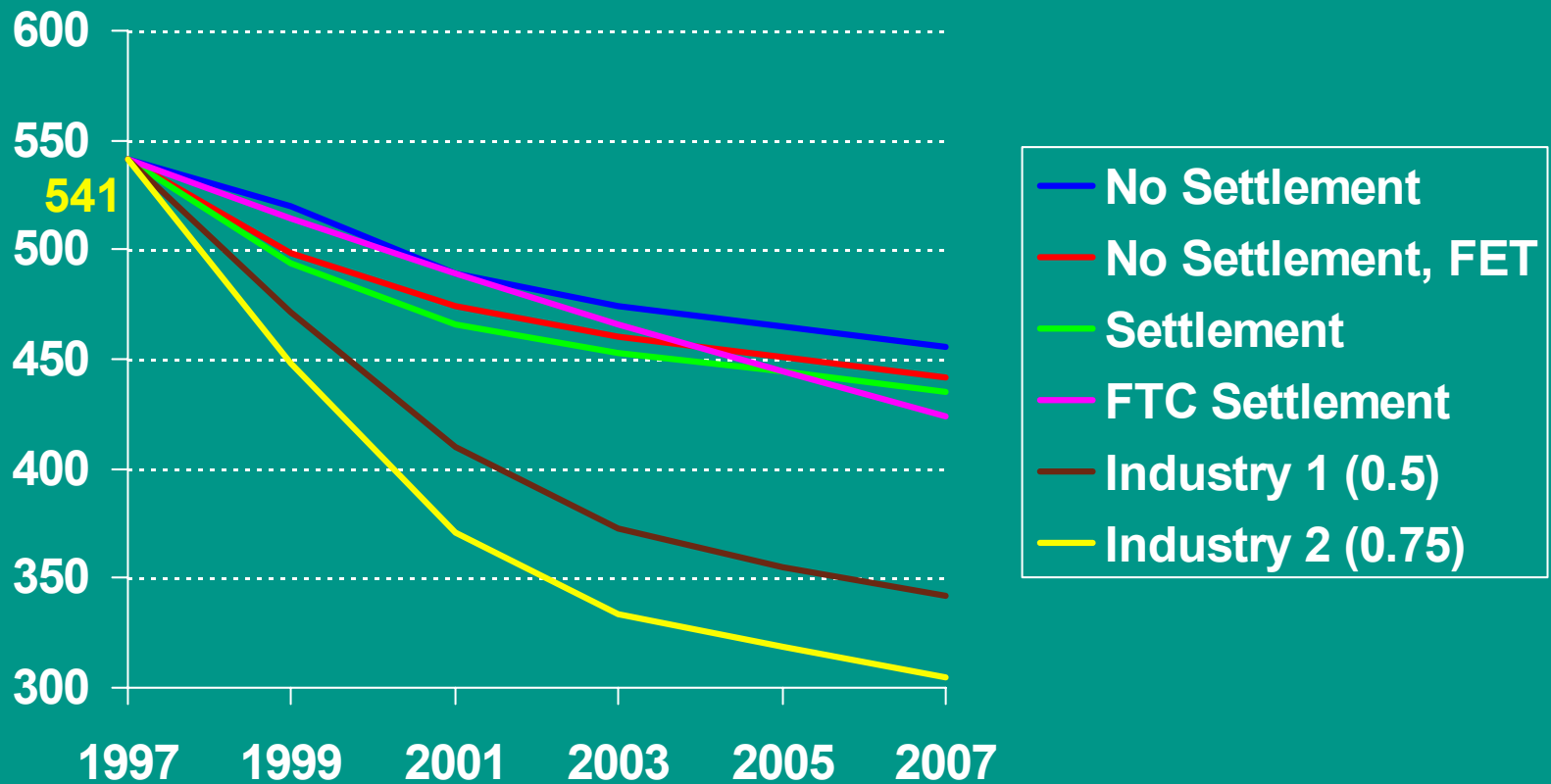


Note: The settlement fund would amount to \$8.5 bn in 1998..

U.S. Cigarette Forecasts (Billions of pieces)



U.S. Leaf Requirements for Cigarette Forecasts (Mns. of pounds)



Farmland Implications

■ Three Proposals for Domestic Flue-Cured Leaf Industry

1. **Retain** Current Tobacco Program
2. **Reallocate** Quota and Restructure Tobacco Program
3. **Eliminate** Tobacco Program
(Deregulate Tobacco Production)

U.S. Flue-Cured Leaf Demand in Five Years

(Based on \$1.20 per Pack Price Increase)

	<u>Flue-Cured</u> <u>Leaf Price</u> (\$/lb.)	<u>Total</u> <u>Demand</u> (mns. of lbs.)	<u>Domestic</u> <u>Demand</u> (mns. of lbs.)	<u>Exports</u> (mns. of lbs.)
Initial Levels	1.73	890	510	380
Proposal 1: No Change in Price	1.73	787	407	380
Proposal 2a: Slightly Lower Price Supports	1.66	864	433	431
Proposal 2b: Lower Price to Maintain Demand	1.62	905	446	459
Proposal 3: Eliminate Program	1.30	1390	590	800

Ford Tobacco Grower Legislation

- Senator Ford (D-KY) introduces **S.1310** on October 23, 1997.
- **Maintains** current tobacco quota system.
- Requires cigarette manufacturers to pay **\$28.5 billion over 25** years for grower and farm community assistance.
- Earmarks \$2.1 billion per year for the first 10 years, and \$500 million annually for years 11 - 25.
- Grants tobacco producers **immunity**.

Robb Tobacco Grower Legislation

- Senator Robb (D-VA) announces November 3, 1997 that he plans to introduce tobacco grower legislation.
- **Limits tobacco production** to present Tobacco Producing Regions.
- **Pays** quota owners **\$8 per pound** for their quota. Five annual installments of \$1.60 per pound based on the 3 year average of basic quota.
- New **privatized program** instituted to give growers only, the right to grow tobacco through the **issuance of licenses**.
- Price support system still exists.

Robb Tobacco Grower Legislation

- **Only** tobacco producers would receive a **license** to grow tobacco.
- **Privatized** authority would **govern** production, marketing, importation, exportation and consumer quality assurance.
- Economic development funds for communities.

Lugar Tobacco Grower Legislation

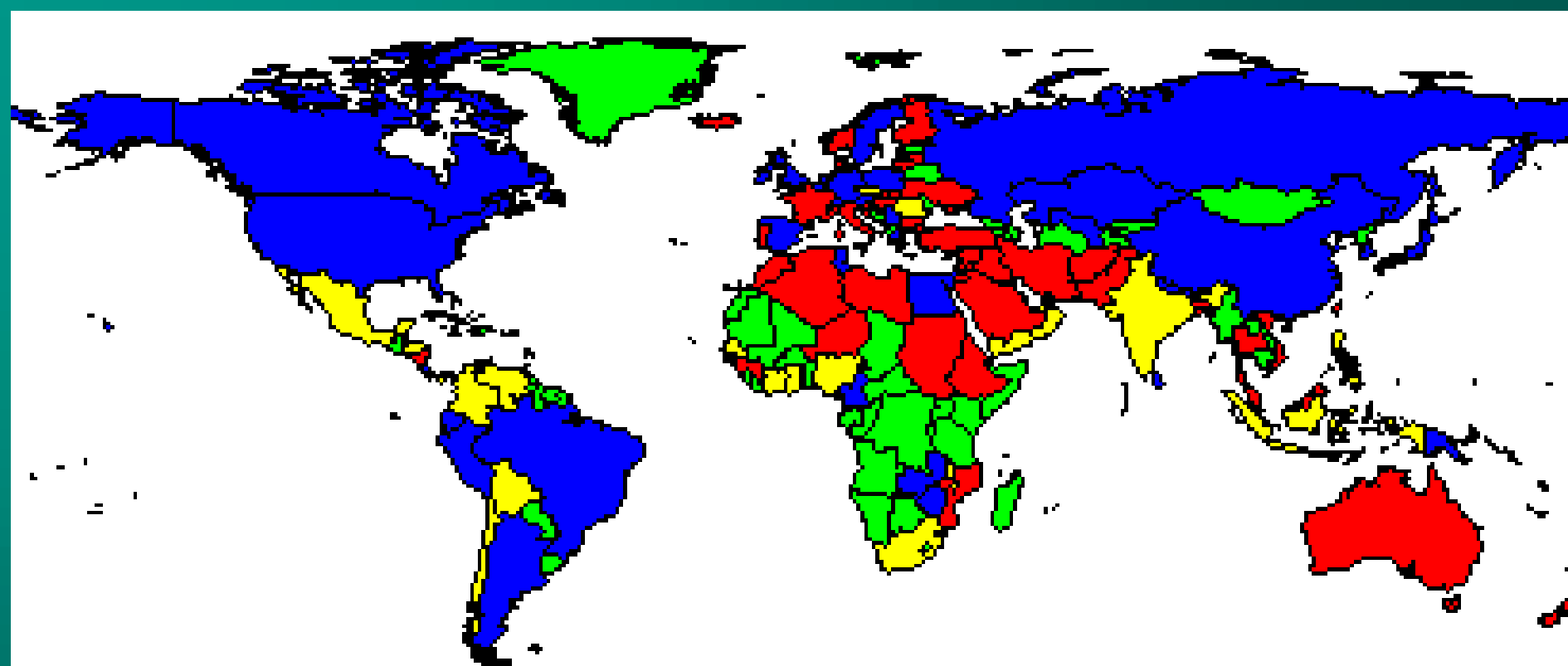
- Senator Lugar (R-IN) introduces S.1313 on October 24, 1997.
- Phases-in the **end** of the tobacco **quota** system beginning in 1999.
- **Pays** quota owners **\$8** for every pound of quota they own.
- Gives tobacco producers **transition payments of 40 cents per pound** over three consecutive years.
- Grants producers the **right to grow** whatever amount of tobacco they choose.
- Provides \$300 million in economic assistance.

Global Trends

- Product Trends
- Financial Trends
- US Settlement & Public Policy Trends
- Emerging Issues and Products

And so the challenges grow...

- More and larger package health warnings covering more of the pack
- Advertising and promotional restrictions all the way to point of sale
- Fewer and fewer places to smoke
- Costing consumers more and more as tax hikes become a public policy instrument of choice
- Fewer ingredients available with more disclosure required pushing us towards generic packagings or at least new overwraps



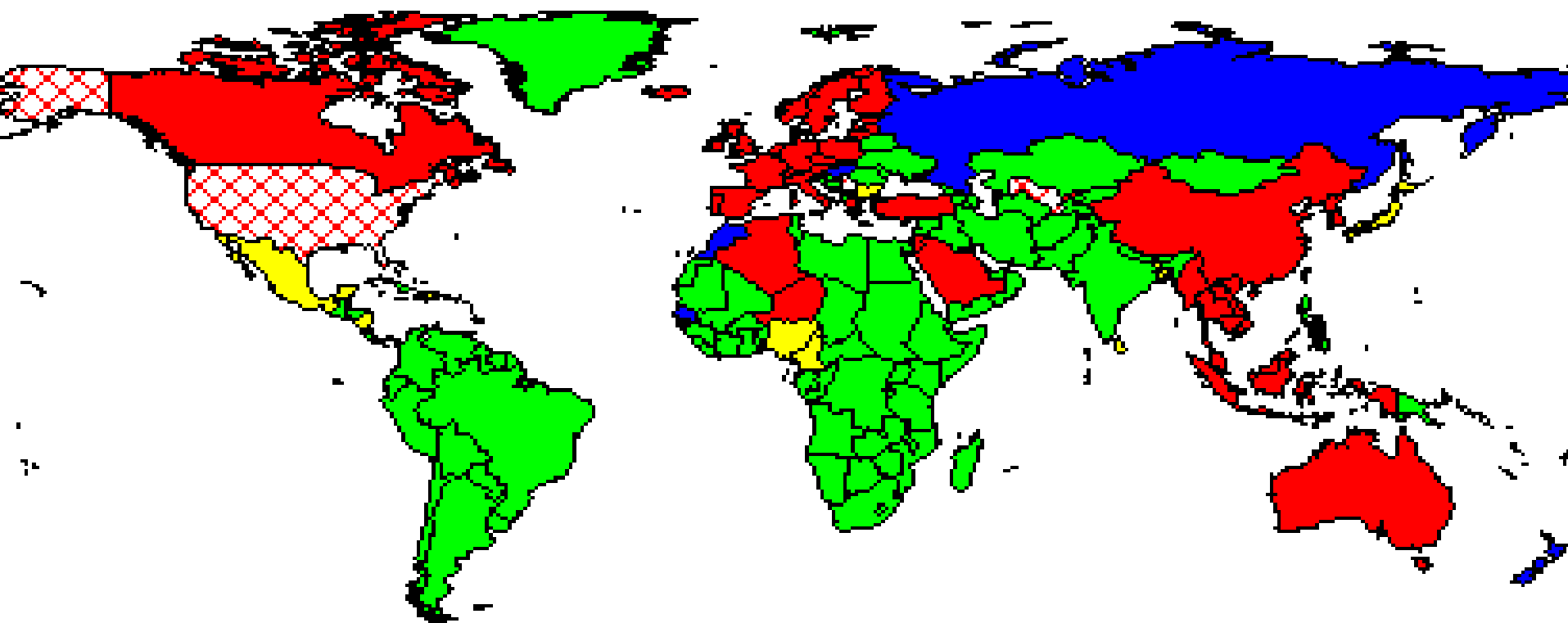
Tobacco Marketing Restrictions: 1997

Tobacco advertising and/or promotional ban.

Broadcast and print restrictions.

Broadcast restrictions.

No restrictions known.



Tobacco Marketing Policies by 2005

Tobacco advertising and/or promotion ban.

Near total promotion ban (Adults only).

Collateral advertising and sponsorship restrictions.

Sponsorship restrictions.

No restrictions known.

RJR's Smokeless Cigarette Products

- **Premier** - In 8/88, RJR test marketed in the U.S. what was considered the first cigarette brand that would produce no ash or environmental tobacco smoke (ETS) when smoked. Smokers, however, criticized the product as “foul tasting” and lacking in flavor. In March 1989, RJR ended the test marketing.
- **Eclipse** - In 6/96, RJR began test marketing the brand that self-contains the entire tobacco burning process and therefore does not release ETS into the air. In early feedback, smokers have regarded the product as fine tasting, but complained that the cigarette is difficult to light.
- **Hi-Q** - Similar to **Eclipse**, this brand is now being sold in Germany.

PM's “De-Nicotined” Cigarette Brand

Next - In 1991, PM test marketed the “de-nicotined” cigarette brand which contained only 0.1 mg of nicotine per cigarette. PM used direct mail sampling in Hartford, CT, Omaha, NE, Toledo, OH, Tampa Bay, FL, and in Arizona to introduce the new product to smokers. After test marketing, PM decided not to launch the product.

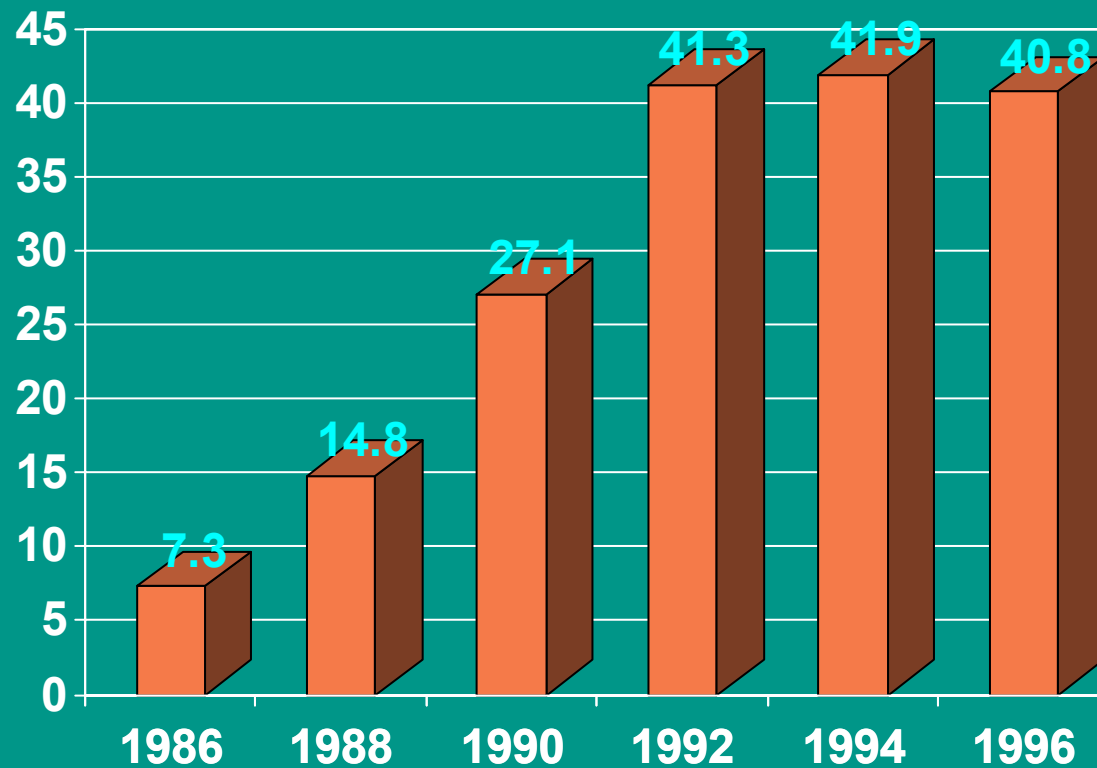
The “All Natural” Movement

- The US-based Santa Fe Tobacco Company's major brand is **Natural American Spirit** which contains only flue-cured tobacco leaf and is sold at a premium price. The brand contains only quality tobacco leaf and no additives. Currently, Santa Fe is buying **organic burley** tobacco at twice the current price for use in another “all-natural” cigarette brand. Sales have exploded and they are going international.
- R.J. Reynolds in June 1996 began test marketing in Florida a “no additives” version of its **Winston** cigarette brand. In July 1997, RJR announced that all **Winston** cigarettes sold in the U.S. will now only be of this variety. Market share has stabilized as a result.
- Canadian-based Imperial Tobacco in August 1997 began test marketing **Mercer**, a “no-additives” brand, in the northwest US.

The Growth of Large Piece Packs in Australia

- Due to the 1990 nationwide ban of cigarette advertising in the print media, the tobacco industry began to seek alternative marketing vehicles at a time when cigarette consumption was slowly declining.
- For the first few years, cigarette marketing meant price-cutting which led to a price war.
- Cigarette companies then began to launch cigarette brands such as Philip Morris' **Longbeach**, Wills' **Horizon**, and Rothmans' **Holiday** which contained 40 and 50 cigarettes per pack. The rise of these big packs reduced the market share of top selling brands such as Rothmans' **Winfield**.

The Proliferation of Large Piece Packs in Australia (% of Total Market)



And We Innovate More...

- Selling cigarettes becomes more like selling alcohol...the growth of controlled sale cigarette stores...large volume single sales
- As each consumer spends \$40 a carton, we realize that at \$2,000 per year we may need to provide financing options...credit cards?
- Mailing lists of smokers become more refined as marketing goes one on one

EMERGING ISSUES

■ The Youth Issue

1. Smoking by Parents -- “Child Abuse”
2. Custody Proceedings in Divorce Cases

■ New & Novel ETS Issues

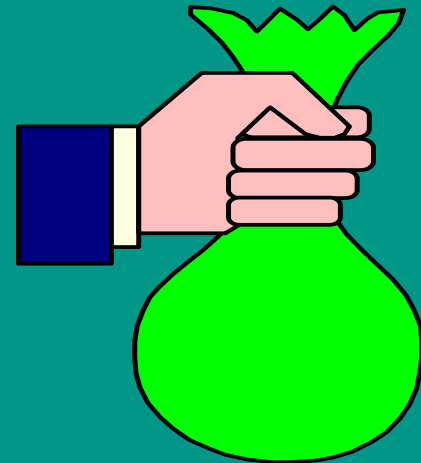
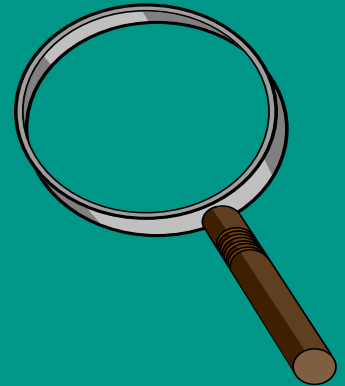
1. Smoking Outdoors
2. Smoking at Home -- Corridors

■ Taxes, Taxes, Taxes -- Alleged Manufacturer Complicity with Smugglers

■ The Insurance Connection: Smoking in Cars; Shortened Lives vs. Health-Care Expenses

Product Standards

- A 250 mm cigarette?
- A magnifying glass with every pack?
- A throw-away overwrap?
- More all-natural products?
- Another Money Trade-Off?



Global Trends

- Product Trends
- Financial Trends
- Public Policy Trends
- Emerging Issues and Products

Relax, Enjoy A Cigar
Everyone Else Is

